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No. 98-2043-CSX Title: Hunt-Wesson, Inc., Petitioner
v.
Franchise Tax Board of California

Docketed: Court: Court of Appeal of California,
June 22, 1999 First Appellate District

Entry Date Proceedings and Orders

Jun 21 1999 Petition for writ of certiorari filed. (Response due August 21, 1999)

Jul 9 1999 Order extending time to file response to petition until August 21, 1999.

Jul 22 1999 Brief amicus curiae of Tax Executives Institute, Inc. filed.

Aug 19 1999 Brief of respondent Franchise Tax Board of California in opposition filed.

Aug 20 1999 Brief amicus curiae of Committee on State Taxation filed.

Aug 31 1999 Reply brief of petitioner Hunt-Wesson, Inc. filed.

Sep 1 1999 DISTRIBUTED. September 27, 1999

Sep 28 1999 Petition GRANTED. The brief of petitioner is to be filed with the Clerk and served upon opposing counsel on or before 3 p.m., Friday, November 12, 1999. The brief of respondent is to be filed with the Clerk and served upon opposing counsel on or before 3 p.m., Monday, December 13, 1999. A reply brief, if any, is to be filed with the Clerk and served upon opposing counsel on or before 3 p.m., Thursday, December 30, 1999. Rule 29.2 does not apply.

SET FOR ARGUMENT January 12, 2000.

Nov 10 1999 Brief amicus curiae of Tax Executives Institute, Inc. filed.

Nov 12 1999 Joint appendix filed.

Nov 12 1999 Brief of petitioner Hunt-Wesson, Inc. filed.

Nov 12 1999 Brief amicus curiae of General Electric Company filed.

Nov 19 1999 CIRCULATED.

Dec 10 1999 Brief of respondent Franchise Tax Board filed.

Dec 10 1999 Brief amici curiae of Idaho, et al. filed.

Dec 13 1999 Brief amicus curiae of Multistate Tax Commission filed.

Dec 15 1999 Record filed.

Dec 29 1999 Reply brief of petitioner Hunt-Wesson, Inc. filed.

Jan 12 2000 ARGUED.

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No. 98-__

Office of the

In The
Supreme Court of the United States

HUNT-WESSON, INC.,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Petition For A Writ Of Certiorari
To The Court Of Appeal Of California
For The First Appellate District

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Under the Commerce and Due Process Clauses, a State may not tax the dividends that a nondomiciliary corporation receives from its nonunitary subsidiaries. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992); *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F. W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354 (1982). California law nevertheless requires that a nondomiciliary corporation reduce its deductible net interest expense – and thereby increase its apportionable income subject to tax – by the amount of such exempt dividends. Moreover, this requirement applies even when the disallowed interest expense is unrelated to the production of the exempt dividend income. The question presented is:

Whether a State may tax constitutionally exempt income under the guise of denying a deduction for expenses in an amount equal to such income when there is no evidence that the expenses relate to the production of the exempt income?

2. Whether a state tax discriminates against interstate commerce in violation of the Commerce Clause by disallowing an otherwise deductible expense, thereby increasing California taxable income, solely because the corporation is not domiciled in the State or does not have subsidiaries that engage in taxable in-state activity?

LIST OF PARTIES

The parties are as stated in the caption. In the courts below, the petitioner was referred to as Hunt-Wesson, Inc., successor in interest to Beatrice Companies, Inc., and as Hunt-Wesson, Inc., formerly known as Beatrice/Hunt-Wesson, a successor by merger with Beatrice Company, formerly known as CagSub, Inc., a successor in interest to Beatrice Companies, Inc., formerly known as Beatrice Foods Company.

RULE 29.6 STATEMENT

Hunt-Wesson, Inc. is a wholly owned subsidiary of ConAgra, Inc. Its non-wholly-owned subsidiaries are ConAgra Brands, Inc. and ConAgra Limited.

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PETITION FOR A WRIT OF CERTIORARI

Hunt-Wesson, Inc. respectfully petitions for a writ of certiorari to review the judgment of the Court of Appeal of the State of California, First Appellate District, Division Three, in this case.

OPINIONS BELOW

The Opinion of the Court of Appeal (App. 1a-13a) is not officially reported. The judgment and statement of the Superior Court of California, City and County of San Francisco (App. 14a-34a), is not officially reported. The California Supreme Court’s denial of Hunt-Wesson’s petition for review (App. 43a) is not officially reported.

JURISDICTION

The judgment of the Court of Appeal was entered on December 11, 1998. The Supreme Court of California denied Hunt-Wesson’s petition for review on March 24, 1999. App. 43a. The jurisdiction of this Court rests on 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, U.S. Const. art. I, § 8, cl. 3, provides: “The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.”

The Due Process Clause of the Fourteenth Amendment to the United States Constitution, U.S. Const.

amend. XIV, § 1, provides: "No State shall . . . deprive any person of life, liberty, or property, without due process of law."

Relevant portions of the California statutes are set forth at App. 35a-38a.

STATEMENT

California denies nondomiciliary corporations a deduction – and thereby increases their California taxable income – in a manner that offends bedrock principles of constitutional law. It does so through three discrete and equally indefensible rules that disallow a deduction for interest expense that is otherwise deductible.¹

First, California arbitrarily allocates all of a nondomiciliary corporation's net interest expense to income that, under the Commerce and Due Process Clauses, California may not tax. California makes this allocation, and thus denies a deduction for the interest expense, even when the interest expense bears no relationship to the constitutionally exempt income. Rather, California's denial of a deduction for interest expense is due solely to the receipt of constitutionally exempt income. As a consequence, California increases nondomiciliary corporations' taxable income base by an amount equal to the exempt income, effectively taxing exempt income in violation of controlling decisions of this Court. *See, e.g., National Life*

¹ California law generally provides that "there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer." Cal. Rev. & Tax. Code § 24344(a).

Ins. Co. v. United States, 277 U.S. 508, 519 (1928) ("[o]ne may not be subjected to greater burdens upon his taxable property solely because he owns some that is free").

Second, California permits domiciliary corporations, but not nondomiciliary corporations, to reduce their taxable income by interest expense deductions to the extent that the corporation receives dividends from nonunitary corporations. Since the allowance or disallowance of the deduction turns entirely on the domicile of the dividend-receiving corporation,² it violates the cardinal principle of this Court's Commerce Clause jurisprudence barring taxes that facially discriminate in favor of in-state over out-of-state entities. *See, e.g., South Cent. Bell Tel. Co. v. Alabama*, 119 S. Ct. 1180 (1999) (striking down franchise tax that favored domestic over foreign corporations).

Third, there is an exception to the arbitrary rule of interest expense allowance described above, but that exception is unconstitutional as well. California does not require a nondomiciliary corporation to reduce its interest expense deduction insofar as it receives dividends from nonunitary corporations that engage in taxable activity in California. But this limited exception to the unconstitutional rule of interest expense deduction disallowance discriminates on its face against interstate commerce by conditioning a tax benefit (the deductibility of interest expense) upon the extent of a corporation's in-state activity. It therefore runs headlong into decisions of

² Respondent Franchise Tax Board acknowledged that the provision at issue here operates to "increase taxes on foreign corporations while reducing those of domestic corporations." *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 7 Cal. 3d 544, 554 (1972).

this Court that have condemned indistinguishable taxing schemes under the Commerce Clause. *See, e.g., Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996) (invalidating intangible property tax exemption that varied with extent of corporation's business activity in the State).

The decision below sustaining California's arbitrary and discriminatory disallowance of interest expense is incompatible with controlling decisions of this Court. If left undisturbed, it will provide a roadmap for evasion of the constitutional restraints on state taxation embedded in this Court's doctrine. By the simple expedient of "denying a deduction" equal to a taxpayer's constitutionally exempt income, even when such expenses are unrelated to the production of such income, States will effectively be able to tax the exempt income in violation of constitutional constraints. Review of the decision below, which raises issues also raised in *F. W. Woolworth Co. and Kinney Shoe Corp. v. Franchise Tax Board*, No. 98-1967 (Petition for Writ of Certiorari filed June 7, 1999), is plainly warranted.

1. Beatrice's Business

The facts of the case are not in dispute. Petitioner Hunt-Wesson, Inc. is the successor in interest to the Beatrice Companies, Inc. ("Beatrice"), the original taxpayer in this case. Beatrice was a Delaware corporation with its commercial domicile in Illinois. During the years at issue (fiscal years ending 1980-82), Beatrice was a diversified company engaged primarily in providing food and food-related products in California and throughout the world.

Beatrice also produced other consumer, industrial, and chemical products.

Beatrice owned certain foreign subsidiaries with which it was not engaged in a unitary business. These nonunitary foreign subsidiaries paid dividends to Beatrice of \$27 million for 1980, \$29 million for 1981, and \$19 million for 1982.

In the operation of its unitary business, Beatrice took out loans and incurred interest expense in connection with these loans. None of these loans was related to borrowings of Beatrice's nonunitary subsidiaries that made the dividend payments to Beatrice described above. Instead, those subsidiaries were responsible for their own borrowings. The outstanding loans amounted to \$794 million for 1980, \$610 million for 1981, and \$1.3 billion for 1982. The interest expense with respect to these loans amounted to \$80 million for 1980, \$55 million for 1981, and \$137 million for 1982.

2. California's Taxing Scheme

California imposes a franchise tax measured by net income on corporations for the privilege of doing business in California. Cal. Rev. & Tax. Code §§ 23151, 23151.1. For a corporation like Beatrice, which is engaged in business within and without the State, California divides the corporation's income into two categories: business income and nonbusiness income. Business income, which is apportioned by formula among all the

States in which the taxpayer does business,³ means "income arising from transactions and activity in the regular course of the taxpayer's trade or business. . . ." Cal. Rev. & Tax. Code § 25120(a). Nonbusiness income, which generally is allocated to a particular State depending on its situs, "means all income other than business income." Cal. Rev. & Tax. Code § 25120(d).

These definitions are generally "quite compatible with the unitary business principle." *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 786 (1992). Under this principle, a State may tax an apportioned share of a nondomiciliary taxpayer's income arising from its unitary business, but generally may not tax income that is not connected with its unitary business (for example, dividend income received from nonunitary subsidiaries).⁴ It is stipulated in this case that "[a]ll of th[e] nonunitary dividends received by Beatrice constituted nonunitary, nonbusiness income not subject to apportionment, or taxation, by the State of California." Joint Stipulation of Facts ("Stip.") ¶ 8, Clerk's Transcript ("CT") p. 58.

³ The formula determines the taxable "slice" of the apportionable "pie" of business income that is fairly attributable to California. During the years at issue, the apportionment percentage was the simple average of three fractions – the taxpayer's in-state property over its total property, its in-state payroll over its total payroll, and its in-state sales over its total sales. Cal. Rev. & Tax. Code § 25128.

⁴ If the nonbusiness income has its situs in the State, e.g., income from real property located in the State but unrelated to the taxpayer's trade or business, then the State may, of course, tax a nondomiciliary taxpayer's income from such property. See Cal. Rev. & Tax. Code § 25124.

California law generally provides that "there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer." Cal. Rev. & Tax. Code § 24344(a). Any interest expense attributable to business income must be subtracted from such income, thereby reducing the income subject to apportionment, and any interest expense attributable to nonbusiness income must be subtracted from such income, thereby reducing the income subject to allocation. CT p. 58.⁵ This reflects the widely accepted principle of income tax law and practice generally and in California that expenses should be allocated to the category of income to which they are properly attributable. See *Great Western Fin. Corp. v. Franchise Tax Bd.*, 4 Cal. 3d 1, 6, 479 P.2d 993 (1971) (quoting 12 Marshall, Cal. Practice, State and Local Taxation (1969)). There is no dispute in this case about the propriety of this principle.

The dispute in this case centers on California's statutory deviation from this principle – the so-called "interest offset" provision – which provides three rules that disallow a deduction for interest expense that is otherwise deductible. Cal. Rev. & Tax. Code § 24344(b).⁶

⁵ The California tax form upon which the interest offset was computed starts with total interest expense. From this amount, nonbusiness interest expense is subtracted, leaving only business interest expense subject to the interest-expense disallowance rule here at issue. Stip. ¶ 11, CT p. 58.

⁶ The statute provides:

If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus

- First, California disallows a deduction for any net interest expense⁷ to the extent that the taxpayer receives nonbusiness interest and dividends – including, as in this case, dividends from nonunitary subsidiaries that California lacks the constitutional power to tax. The statute disallows this expense even when the interest expense is unrelated to the production of the dividend income.
- Second, California permits domiciliary corporations, but not nondomiciliary corporations, to reduce their taxable income by interest expense deductions in the amount of dividends received from nonunitary corporations. The preferential treatment persists regardless of whether the interest expense bears any relationship to the production of the dividends in question.
- Third, California provides a limited exception to the rule denying the interest expense deduction

the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula.

Cal. Rev. & Tax. Code § 24344(b).

⁷ California permits a taxpayer to offset its business interest expense against its "interest income subject to allocation by formula," Cal. Rev. & Tax. Code § 24344(b), *i.e.*, apportionable or "business" interest income. Hence, it is the "net" business interest expense – the interest expense attributable to business income that remains after subtracting apportionable interest income – that is at issue here.

to nondomiciliaries, but only to the extent that the dividends derive from corporations that are taxable in California.⁸

3. The Assessment

During the audit of Beatrice for the years at issue, the Franchise Tax Board (the "Board") applied the interest offset provision and disallowed Beatrice's net interest expense on a dollar-for-dollar basis by the amount of the constitutionally exempt dividend income Beatrice received from its nonunitary subsidiaries. The basis for the Board's disallowance of Beatrice's interest expense deduction was simply that Beatrice had received nonbusiness dividends. *Stip.* ¶ 14, CT p. 59. The Board made no determination that the interest expense bore any relationship to the constitutionally exempt dividends, and the statute did not require that it do so. As a consequence, the Board reduced Beatrice's interest expense, and increased its business income subject to apportionment by California, by the amount of the exempt dividend

⁸ Under Cal. Rev. & Tax. Code § 24344(b), a taxpayer must reduce its otherwise deductible interest expense by dividends received from nonunitary corporations "except dividends deductible under the provisions of Section 24402." Dividends deductible under Cal. Rev. & Tax. Code § 24402 are dividends declared from income that has already been subject to tax in California. Accordingly, the exception to the required reduction in deductible interest expense – and the consequent increase in California taxable income – is correlated to the proportion of the taxpayer's dividend-paying subsidiaries' business that is conducted in California.

income: \$27 million for 1980, \$29 million for 1981, and \$19 million for 1982. This resulted in tax deficiencies of \$139,066, \$170,486, and \$109,640, respectively.

4. The Proceedings Below

In March 1996, Petitioner filed suit for a refund of taxes and interest in the Superior Court, City and County of San Francisco. Verified Complaint for Refund of Taxes ("Complaint"), CT p. 1. Petitioner alleged, among other things, that Cal. Rev. & Tax. Code § 24344(b) violated the Commerce and Due Process Clauses of the United States Constitution⁹ by arbitrarily limiting its interest expense deduction by the amount of its constitutionally exempt dividend income. Complaint ¶¶ 21-22, CT p. 4.

(a) **The Superior Court.** In June 1997, the Superior Court found that Cal. Rev. & Tax. Code § 24344(b) violated the Commerce and Due Process Clauses. Turning first to the Due Process Clause claim, the court grounded its analysis in two basic, and undisputed, principles: first, "that a state may not tax plaintiff's nonbusiness dividends because plaintiff is a foreign nondomiciliary corporation and such income is only taxable in its state of domicile"; second, "that a state cannot tax indirectly that which it may not tax directly." App. 22a. These principles, the court reasoned, led inexorably to the conclusion that California's disallowance of Beatrice's interest expense

⁹ Petitioner additionally argued at trial and on appeal that Cal. Rev. & Tax. Code § 24344 violated the Equal Protection Clause of the Fourteenth Amendment. Although petitioner is not pressing that claim here, the claim is being pursued in Docket No. 98-1967.

deduction violated the Due Process Clause because "[i]t disallows interest deductions on a dollar-for-dollar basis with non-taxable dividend income without regard to whether or not such interest is *related* to the dividend income." App. 26a (emphasis in original).

The court recognized that California might constitutionally deny an interest expense deduction that was related to income that California could not tax. App. 26a. But "such potential legitimate state purpose" (App. 26a) simply had no application to this case because

here the parties have stipulated that no portion of the proceeds of the loans generating the interest expense deductions herein went to any non-unitary corporation, each of which was responsible for its own borrowings. (J.S. ¶ 9). Thus, it appears that no portion of the interest expense deduction can be attributable to the generation of the . . . exempt dividends.

App. 26a-27a.

The court likewise found that Cal. Rev. & Tax. Code § 24344(b) violated the Commerce Clause. Because only domiciliary corporations received any tax benefit from the offset of interest expense against nonunitary dividends, the court observed that it will always be true that "the amount of tax on a foreign corporation under Rev. & T.C. §24344(b) will be higher than that of a domestic corporation where both have a) the same taxable business income; b) the same interest expense deductions; and c) the same dividend income." App. 29a. This discrimination against foreign corporations, the court concluded, could not be squared with this Court's precedents barring discrimination against out-of-state corporations.

App. 28a-29a (citing, among other cases, *Fulton; Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997), and *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984)). Moreover, the differential treatment of in-state and out-of-state corporations could not be justified by any purported relationship of the interest expense to the nonunitary dividends, since the record was clear that no such relationship existed. App. 30a.

(b) **The Court of Appeal.** In December 1998, the Court of Appeal reversed the decision of the Superior Court. The Court of Appeal conceded that, "[i]f we were writing on a clean slate," petitioner's arguments "might appear persuasive." App. 8a. Nevertheless, the Court of Appeal believed it was bound by a 1972 decision of the California Supreme Court, *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 7 Cal. 3d 544, 498 P.2d 1030 (1972) ("*Pacific Telephone*"), which upheld the Board's interpretation of Cal. Rev. & Tax. Code § 24344(b), even though the Court of Appeal admitted that "the *Pacific Telephone* case did not involve a constitutional challenge to section 24344." App. 8a.

In rejecting petitioner's contention that the disallowance of an interest deduction based on the receipt of tax-exempt dividends effectively taxed such dividends in violation of the Due Process Clause, the Court of Appeal felt constrained by the determination of the California Supreme Court in *Pacific Telephone* that the "inclusion of nontaxable dividends in the statutory offset computation under section 24344 does not constitute taxation of the dividends themselves." App. 8a. Rather than defending this position, the court below simply declared that "[w]e defer, as we must, to that decision," even though *Pacific*

Telephone was not based on constitutional considerations. App. 8a.

In dismissing petitioner's Commerce Clause argument, the Court of Appeal again relied principally on "our Supreme Court's holding in *Pacific Telephone* that the interest offset provision does not constitute a tax on the dividends in question." App. 9a. Hence Commerce Clause restraints applicable to taxes were not relevant because "our high court has held the interest offset provision is not a tax on the income in question here." App. 12a. The court found this Court's decision in *Fulton* distinguishable, even though it struck down a statute like California's which conferred a tax benefit based on the extent of a taxpayer's in-state presence, on the ground that here the "alleged favorable effect on local commerce is indirect and incidental." App. 9a. As for the long line of cases from this Court holding facially discriminatory taxes violative of the Commerce Clause, the Court of Appeal found them "not determinative" because "[i]n the absence of a directly applicable ruling by the federal Supreme Court holding unconstitutional an interest offset provision such as the one in issue here, we remain bound by *Pacific Telephone*." App. 10a.¹⁰

(c) **The California Supreme Court.** On March 24, 1999, the California Supreme Court denied Hunt-Wesson's petition for review. App. 43a.

¹⁰ The Court of Appeal did not certify its opinion for publication, which means that, with certain exceptions, it may not be cited as binding precedent in California.

REASONS FOR GRANTING THE PETITION

The decision of the California Court of Appeal warrants review by this Court for two compelling reasons. First, the Court of Appeal's determination is irreconcilable with controlling decisions of this Court. These decisions make it clear that a State may not increase a taxpayer's taxable income just because it receives other income that is tax-free. Yet that is precisely the effect of the California interest offset provision. This Court's decisions make it equally clear that a State may not limit a tax benefit to its own domiciliaries or to those who invest in corporations conducting in-state rather than out-of-state activity. Yet that too is the inexorable effect of Cal. Rev. & Tax. Code § 24344(b).

Second, the Court of Appeal's decision, if allowed to stand, would open a gaping hole in the constitutional structure that protects state taxpayers from illegal exactions. If respondent is right, and a State may constitutionally increase a taxpayer's income merely by disallowing a deduction equal to constitutionally exempt income, even when there is no justification for denying the deduction other than the receipt of such exempt income, then the constitutional restraints on state taxation of such exempt income are virtually meaningless. The significance of such a holding extends far beyond the 40,000 corporations who file income tax returns reporting activities within and without California¹¹ – the world's

¹¹ Letter from California Attorney General Bill Lockyer to the Court of Appeal, Jan. 4, 1999. App. 39a-42a.

seventh largest economy.¹² It extends to every multistate taxpayer in every State, which will now be empowered to tax the multistate taxpayer's constitutionally exempt income by the simple device of disallowing a deduction equal to such income. The extraordinary implications of such a rule, which undermine essential constitutional restraints on state taxation, require review by this Court.

I. THE DECISION BELOW CONFLICTS WITH SETTLED DECISIONS OF THIS COURT

A. California's Denial of a Deduction for Interest Expense Violates the Well-Settled Rule that a State May Not Tax Constitutionally Exempt Income Under the Guise of Denying a Deduction for Expenses Equal to Such Exempt Income

The practical effect of Cal. Rev. & Tax. Code § 24344(b) is to tax income that is constitutionally exempt from tax. This conclusion follows from three essentially undisputed propositions. First, the dividends that Beatrice received from its nonunitary subsidiaries are not constitutionally taxable by California. *See* Stip. ¶ 8, CT p. 57; *see also* *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F. W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354 (1982). Second, the only reason why respondent disallowed Beatrice's interest expense is because Beatrice received such constitutionally exempt income. *See* Stip. ¶ 12, CT p. 58. Third, as the trial court observed, "it appears that no portion of the interest

¹² California Trade and Commerce Agency, Office of Economic Research, *California: An Economic Profile*, p. 9 (1998).

expense deduction can be attributable to the generation of the . . . exempt dividends." App. 27a. It is therefore plain that the increase in Beatrice's taxable income is attributable to the receipt of exempt income, which the interest expense did not generate, and that the practical effect of Cal. Rev. & Tax. Code § 24344(b) is to tax Beatrice's exempt dividends.

The California Court of Appeal viewed the essential dispute in this case as whether the *legal* effect of Cal. Rev. & Tax. Code § 24344(b) is the same as its *practical* effect. Relying on the California Supreme Court's opinion in *Pacific Telephone*, it concluded that the answer to this question is no. In its view, the legal effect of denying a deduction is different from its practical effect on the ground that "inclusion of nontaxable dividends in the statutory offset computation under section 24344 does not constitute taxation of the dividends themselves." App. 8a. Such elevation of form over substance, however, has no place in constitutional analysis,¹³ as it runs counter to a long line of this Court's decisions.

It is, of course, "a just and well-settled doctrine established by this court, that a State cannot do that indirectly which she is forbidden by the constitution to

¹³ The Court has made it clear in analyzing constitutional restraints on state taxes that its decisions "consider[] not the formal language of the tax statute but rather its practical effect," *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977); that they evaluate "state taxation based upon its actual effect rather than its legal terminology," *American Trucking Ass'ns, Inc. v. Scheiner*, 483 U.S. 266, 295 (1987); and that they are grounded in "economic realities." *Id.*

do directly." *Passenger Cases*, 48 U.S. 283, 458 (1848) (plurality opinion). The Court has consistently applied this "great principle" (*id.* at 459) to invalidate state exactions that purport to tax indirectly what the Constitution forbids States from taxing directly. *See, e.g., id.* (striking down an exaction on foreign passengers as a prohibited "duty on tonnage," U.S. Const. art. I, § 10, cl. 3); *Frick v. Pennsylvania*, 268 U.S. 473, 495 (1925) (striking down state estate tax on the ground that "[i]t would open the way for easily doing indirectly what is forbidden to be done directly, and would render important constitutional limitations of no avail"); *Lee v. Osceola & Little River Rd. Improvement Dist. No. 1*, 268 U.S. 643 (1925) (striking down state tax scheme that would "accomplish indirectly the collection of a tax against the United States which could not be directly imposed").

California's interest offset provision is a paradigmatic example of a State's effort to tax indirectly what it may not tax directly. By reducing an otherwise allowable interest expense deduction on a dollar-for-dollar basis by the amount of dividend income it may not constitutionally tax, California increases a nondomiciliary corporation's tax base by the exact amount of the exempt income. Because the statute does not require – and the facts do not reveal – any relationship between the disallowed interest expense and the nontaxable income, the effect is simply to tax the exempt income.

This Court has condemned, in general, efforts like California's to evade constitutional restrictions on state taxing power by circuitous means. It also has condemned specifically, in a related context, the precise mechanism that California seeks to employ here to tax the exempt

income. In *National Life Ins. Co. v. United States*, 277 U.S. 508 (1928), this Court struck down a provision of the federal income tax law which permitted insurance companies to exclude municipal bond interest from their gross income but at the same time required the insurance companies to reduce an unrelated deduction for reserves by the full amount of the exempt interest. In other words, for each dollar of tax-exempt income the taxpayer received, it had to reduce an otherwise allowable deduction by one dollar. Treating the disallowance of the deduction for what it was – a transparent effort to tax exempt income by denying an unrelated deduction in the same amount – the Court ruled that “[o]ne may not be subjected to greater burdens upon his taxable property solely because he owns some that is free.” *Id.* at 519.

The statutory provision invalidated in *National Life* is remarkably similar to the California provision at issue here. In each case, a taxpayer is ordinarily entitled to claim a deduction that reduces its income tax base; in each case the taxpayer is required to forgo the deduction, and thereby increase its taxable income, by the amount of its exempt income; and in each case, the deduction need not – and does not – bear any relationship to the exempt income in question. In short, the Court of Appeal’s decision sustaining California’s interest offset provision cannot be squared with the rationale of *National Life* – that one may not be subjected to greater burdens upon taxable income solely because one receives income that is tax-exempt.¹⁴

¹⁴ As noted above (*see supra*, p. 9), California’s interest offset provision cannot be defended on the ground that it serves

B. California’s Provision of More Favorable Interest Expense Deductions for Domiciliary Than for Nondomiciliary Corporations Flies in the Face of This Court’s Controlling Commerce Clause Decisions

The rule prohibiting taxes that discriminate against interstate commerce is a central tenet of this Court’s Commerce Clause doctrine. *See, e.g., Oregon Waste Sys., Inc. v. Department of Envtl. Quality*, 511 U.S. 93 (1994). No aspect of this doctrine is more firmly established than the principle that a State may not favor in-state over out-of-state entities. Indeed, just a few months ago, the Court applied this principle in striking down Alabama’s franchise tax in *South Cent. Bell Tel. Co. v. Alabama*, 119 S. Ct. 1180 (1999). Alabama’s taxing scheme favored domestic over foreign corporations by giving domestic – but not

to match interest expense with the income it produces. Beatrice made no direct operating loans to its dividend-paying subsidiaries, which were responsible for their own borrowings. Stip. ¶ 9, CT p. 58. Nor is there any evidence in the case linking the interest expense even indirectly to the subsidiaries’ income-producing activities. Indeed, rather than disputing the proposition that “the interest offset is overbroad, because it fails to apportion interest expense,” App. 8a, the Court of Appeal acknowledged the proposition’s “persuasive” force (App. 8a), but felt compelled to follow the earlier ruling of the California Supreme Court in *Pacific Telephone*. *See supra*, pp. 12-13. Moreover, the interest offset provision cannot be justified as a provision designed to match interest expense to exempt nonbusiness income, because any nonbusiness interest expense already is excluded as a deduction before the interest offset is computed. Stip. ¶ 11, CT p. 58. Accordingly, the interest offset operates only to match deductible interest expense with nontaxable income – a practice that is incompatible with controlling doctrine and case law.

foreign – corporations the ability to reduce their franchise tax liability by reducing the par value of their stock. *Id.* at 1185-86. Observing that the tax “facially discriminates against interstate commerce,” *id.*, a unanimous Court invalidated the tax in short order.

California’s preference for its own domiciliary corporations is no different in substance from Alabama’s domestic preference legislation condemned in *South Central Bell*. As in *South Central Bell*, there can be no dispute that the taxing scheme in question treats local corporations more favorably than their out-of-state competitors: only domiciliary corporations receive the full benefit of an interest expense deduction against taxable income when they receive dividends from nonunitary corporations. Nondomiciliary corporations, by contrast, must forgo the benefit of the interest expense deduction to the extent of their nonunitary dividends. The preferential treatment persists regardless of whether the interest expense bears any relationship to the production of the dividends in question. Since the allowance or disallowance of the deduction turns entirely on the domicile of the dividend-receiving corporation, it violates the “virtually per se rule of invalidity” that this Court applies to facially discriminatory taxes. *See, e.g., Camps/Newfound Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 596 (1997).

Contrary to the suggestion of the court below, it is of no constitutional moment that California’s disparate treatment of nondomiciliary corporations takes the form of the discriminatory denial of a deduction rather than the discriminatory imposition of a tax. *See App. 9a* (“the interest offset provision does not constitute a tax on the

dividends in question”). The Commerce Clause bars discrimination against interstate commerce “whether forthright or ingenious.” *Best & Co. v. Maxwell*, 311 U.S. 454, 455 (1940). This Court’s opinions attest to the fact that the form of the tax preference – be it the discriminatory imposition of a tax or the discriminatory denial of an exemption, deduction, or credit – is constitutionally irrelevant.¹⁵

C. California’s Allowance of Interest Expense Deductions Based on the Extent to Which a Corporation’s Subsidiaries Conduct Business in California Is Indistinguishable from the State Taxing Scheme Condemned in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996)

California not only discriminates in favor of domiciliary over nondomiciliary corporations, but also discriminates against interstate commerce in another (and equally offensive) way. California does not deny an interest

¹⁵ *See Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388, 404-05 (1984) (“Nor is it relevant that New York discriminates against business carried on outside the State by disallowing a tax credit rather than by imposing a higher tax. The discriminatory economic effect of these two measures would be identical. . . . We have declined to attach any constitutional significance to such formal distinctions that lack economic substance.”); *Maryland v. Louisiana*, 451 U.S. 725, 756 (1981) (“the Louisiana First-Use Tax unquestionably discriminates against interstate commerce . . . as the necessary result of various tax credits and exclusions”); *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 211 (1994) (Scalia, J., concurring) (an “‘exemption’ from or ‘credit’ against a ‘neutral’ tax, is no different in principle from [a discriminatory tax], and has likewise been held invalid”).

expense deduction to a nondomiciliary corporation insofar as it receives dividends from nonunitary corporations that engage in taxable activity in California. But this limited exception to the unconstitutional rule denying an interest expense deduction itself discriminates on its face against interstate commerce by conditioning a tax benefit (the deductibility of interest expense) on the extent of a corporation's in-state activity. In this respect, California's interest offset provision is virtually identical to the North Carolina taxing scheme this Court struck down in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).

In *Fulton*, the Court considered a North Carolina intangible property tax as applied to taxpayers who owned corporate stock. The tax was imposed at the rate of 0.25 percent of the fair market value of the stock. The value of the stock assessed under the tax, however, was reduced by a percentage equal to the percentage of the corporation's income subject to tax in North Carolina. Under this regime, if the stock was issued by a corporation doing all of its business in North Carolina, a 100 percent reduction of the value of the stock would be allowed; if the stock was issued by a corporation doing 50 percent of its business in North Carolina, a 50 percent reduction of the value of the stock would be allowed; and if the stock was issued by a corporation doing none of its business in North Carolina, no reduction of the value of the stock would be allowed.

The Court had no hesitation in branding North Carolina's taxing scheme as "facially" discriminatory (*id.* at 333):

A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.

Id.

California's interest offset scheme suffers from precisely the same constitutional infirmity. It permits an interest deduction against taxable income (and thus a reduction in California tax) only to the extent that a nonunitary, dividend-paying subsidiary does business in California. Thus, just as in North Carolina, the taxpayer receives a tax benefit only insofar as the corporation in which it has invested is doing business in the State. If the taxpayer's nonunitary, dividend-paying subsidiary were doing all of its business in California, a 100 percent deduction of the taxpayer's otherwise deductible interest expense would be allowed; if the taxpayer's nonunitary, dividend-paying subsidiary were doing 50 percent of its business in California, 50 percent of the taxpayer's otherwise deductible interest expense would be allowed; and if the taxpayer's nonunitary, dividend-paying subsidiary were doing none of its business in California, none of the taxpayer's otherwise deductible interest expense would be allowed.

The Court's conclusion with regard to the North Carolina regime applies equally to the California regime:

A regime that [denies an interest deduction] only to the degree that [the dividend-paying subsidiary] participates in interstate commerce

favors domestic corporations over their foreign competitors in raising capital among [California] residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.

Fulton, 516 U.S. at 333. Accordingly, Cal. Rev. & Tax. Code § 24344(b) "facially discriminates against interstate commerce." *Id.*

II. IF ALLOWED TO STAND, THE DECISION BELOW WILL SERIOUSLY UNDERMINE CONSTITUTIONAL RESTRAINTS ON STATE TAXATION

The decision below poses a serious threat to constitutional restraints on state taxation by allowing a State to evade those restraints through the simple expedient of disallowing a deduction for expenses equal – but unrelated – to constitutionally exempt income. If left undisturbed, it will provide a roadmap for circumvention of the most basic of constitutional limitations embedded in this Court's doctrine – namely, the bar against taxing income with which the State has no connection. If a State can increase its income subject to tax by the transparent device of denying an expense equal – but unrelated – to income which is constitutionally exempt from tax, then the bar on taxing such exempt income is illusory. Yet that is precisely what California has done here.

The impact of the Court of Appeal's decision is not merely theoretical. The California Attorney General, in a

letter urging the Court of Appeal to publish the decision below,¹⁶ declared:

The question answered in the *Hunt-Wesson* case is whether Revenue and Taxation Code Section 24344(b) is constitutional. The constitutionality of a section of the Revenue and Taxation Code is of great significance to the taxpayers and the state. Over 40,000 corporations file returns which report their activities both within and without California. These corporations pay over 70% of the bank and corporation tax collected by California. Each of these corporations has the potential to have income which is apportioned by formula and income which is not apportioned by formula so that the amount of interest expense and the manner in which it will be taken into account is governed by Section 24344(b).

Letter from California Attorney General Bill Lockyer to the Court of Appeal, Jan. 4, 1999. App. 39a-42a.

California is the world's seventh largest economy¹⁷ – with corporate franchise tax revenues alone of more than \$5.8 billion.¹⁸ Even if the impact of the decision below were limited to California, it would warrant this Court's review because of the enormous effect it will have on

¹⁶ As noted above, *see supra* note 10, the Court of Appeal did not certify the decision below to be published.

¹⁷ California Trade and Commerce Agency, Office of Economic Research, *California: An Economic Profile*, p. 9 (1998).

¹⁸ California State Comptroller's Office, *State of California Comprehensive Annual Financial Report for the Year Ended June 30, 1998*.

multistate taxpayers, the overwhelming majority of which do business in California.

But the impact of the Court of Appeal's decision is not so limited. If the decision below is left undisturbed, it will pave the way for every State to avoid the constitutional limitations on its taxing powers. The decision below, after all, stands for a proposition of astonishing breadth: A State may constitutionally increase a taxpayer's income merely by disallowing an expense deduction equal to constitutionally exempt income, even when there is no evidence of any relationship between the disallowed expense and the exempt income. Moreover, the States are well aware of the *Hunt-Wesson* case, since it has been the topic of frequent discussion in the state tax literature¹⁹ and at state tax conferences.²⁰

¹⁹ See, e.g., Wethekam & Egr, *State and Local Tax Update*, State Tax Today (Sept. 3, 1998); Rosen & Smith, 1997 *National State and Local Tax Developments*, State Tax Today (Mar. 17, 1998); Wright, *California's Interest Offset Runs into a Constitutional Glitch*, State Tax Today (Nov. 13, 1997); Herbert, Stanislawski & Kessler, *Defending the Castle Walls: California's Interest Offset, Dividends Received Deduction Should Crumble Soon*, State Tax Today (Oct. 29, 1997); Multistate Tax Analyst, *Discriminatory Taxation - California: Interest Offset Requirement Survives Constitutional Challenge*, Vol. 11, No. 8, p. 6 (Mar. 31, 1999); cf. J. Hellerstein & W. Hellerstein, *State Taxation*, Vol. 1, ¶¶ 4.13[2][k][v], 9.10[1][e][ii] (3d ed. 1998) (discussing the Superior Court's decision).

²⁰ See, e.g., Willson, *Current Developments in State and Local Taxation: A Nationwide Perspective*, Georgetown University Law Center Continuing Legal Education State and Local Tax Institute (May 20, 1999); Uzes, McIntyre & Leung, *The Allocation of Expenses - Testing the Limits of California's Taxing Scheme*, 1998 California Tax Policy Conference: Issues in State Taxation (Nov.

In short, the decision below has implications not only for California, but for every State and for every taxpayer that conducts business across state lines. Unless quickly repudiated, the decision will allow California effectively to continue to tax income that is beyond its constitutional reach and is likely to embolden other States to follow California's lead. In these circumstances, this Court should grant review of the decision below.

CONCLUSION

For the reasons set forth above, the petition for certiorari should be granted.

Respectfully submitted,

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11-13, 1998); Miller, Green, & Nielsen, *Litigation - Past, Present and Future*, 1997 California Tax Policy Conference: Issues in State Taxation (Nov. 5-7, 1997).

APPENDIX A

NOT TO BE PUBLISHED IN OFFICIAL REPORTS
IN THE COURT OF APPEAL OF THE
STATE OF CALIFORNIA
FIRST APPELLATE DISTRICT
DIVISION THREE

HUNT-WESSON, INC.,)	
Plaintiff and Respondent,	)	(Filed Dec. 11,
	)	1998)
v.)	
FRANCHISE TAX BOARD,)	
Defendant and Appellant.	)	A079969
	)	(San Francisco
	)	County
	)	Super. Ct. No.
	)	976628)

The Franchise Tax Board (the Board) appeals from a judgment ordering the refund of over \$2 million in franchise taxes and interest to respondent Hunt-Wesson, Inc. (Hunt-Wesson). The Board contends the trial court erred in holding unconstitutional Revenue and Taxation Code section 24344.¹ We agree, based on our Supreme Court's decision in *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.* (1972) 7 Cal.3d 544 (*Pacific Telephone*), and therefore reverse the judgment.

¹ Subsequent statutory references are to the Revenue and Taxation Code.

Factual and Procedural Background

Respondent Hunt-Wesson is a Delaware corporation, domiciled in Illinois, and engaged in business in California and elsewhere.² During the relevant years, respondent owned, and received dividends from, certain nonunitary subsidiaries, none of which were incorporated in California and most of which were incorporated under the laws of a foreign country. The dividends constituted nonunitary, nonbusiness income and were not subject to apportionment, or taxation, by California.³ Respondent made no direct operating loans to the subsidiaries during the relevant years.

Respondent claimed deductions for certain business interest expenses on its California franchise tax returns. Following an audit, the Board disallowed the deductions, dollar for dollar, to the extent the dividends were received from nonunitary subsidiaries, pursuant to the interest offset provision of section 24344. Respondent paid the proposed deficiencies⁴ and filed a timely claim for refund. The case was submitted on stipulated facts, and the trial court ruled that section 24344 violates the Due Process, Equal Protection, and Commerce Clauses of

² The facts are summarized from the parties' Joint Stipulation of Facts. Hunt-Wesson is a successor in interest to Beatrice Companies, Inc. and Beatrice Foods Company, also Delaware corporations domiciled in Illinois.

³ The dividends were taxable by Illinois, respondent's state of domicile.

⁴ Respondent also agreed to permit the Board to credit an overpayment against the proposed deficiencies.

the United States Constitution. This appeal followed an order of refund below.

Issue on Appeal

Whether the interest offset provision of section 24344 is unconstitutional is a question of law over which this court exercises independent review. (*GTE Sprint Communications Corp. v. State Bd. of Equalization* (1991) 1 Cal.App.4th 827, 832.) "The power of the Legislature in the area of taxation is paramount, and any constitutional restriction on that power must be strictly construed against the limitation. [Citation.]" (*Franchise Tax Bd. v. Superior Court* (1989) 212 Cal.App.3d 1343, 1347.) Every statute is presumed constitutional (*County of Sonoma v. State Energy Resources Conservation etc. Com.* (1985) 40 Cal.3d 361, 368), and must be upheld unless it is " 'clearly, positively, and unmistakably' " unconstitutional. (*Calfarm Ins. Co. v. Deukmejian* (1989) 48 Cal.3d 805, 814.) Any doubt must be resolved in favor of the legislation; even if its validity is "fairly debatable," it must nonetheless be sustained. (*Id.* at pp. 814-815.)

When a corporation derives income from sources both within and outside the state, California's corporate franchise tax is measured by net income attributable to in-state sources. (§§ 23151, 25101.) California follows the Uniform Division of Income for Tax Purposes Act (UDITPA) (§ 25120 et seq.), which makes a distinction between business and nonbusiness income.⁵ Business

⁵ Business income is defined as "income arising from transactions and activity in the regular course of the taxpayer's

income is generally calculated by applying an apportionment formula based on sales, property and payroll to the corporation's unitary business income. (§ 25128.) Non-business dividend income is not apportioned, but is taxable by the corporation's state of domicile. (§§ 25123, 25126.)

In calculating taxable net income under the apportionment approach, section 24344 provides for the deduction of interest expense, subject to certain limitations.⁶ Pursuant to subsection (b), interest expense is fully deductible to the extent of business interest income. Additional interest expense is then offset against non-business interest and dividend income (which is not subject to allocation by formula), with the remaining interest

trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." (§ 25120, subd. (a).) Nonbusiness income is "all income other than business income." (§ 25120, subd. (d).)

⁶ For the relevant years, former section 24344 provided: "(a) Except as limited by subsection (b), there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer. [¶] (b) If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula."

deductible. Applying this section, the Board disallowed Hunt-Wesson's interest expense deduction on a dollar-for-dollar basis to the extent it received dividends from its nonunitary subsidiaries. Hunt-Wesson claims the application of the interest offset provision violates the Due Process and Commerce Clauses because it indirectly taxes nonbusiness dividends which could not be taxed directly, and discriminates against corporations domiciled outside California. Hunt-Wesson also argues the statute violates the Equal Protection Clause by creating an irrational classification that discriminates solely on the basis of a corporation's state of domicile.

Division One of this court recently noted that "[t]he theory of this interest offset rule is that a corporation should not be able to borrow money to purchase stocks that pay dividends and then get a deduction for the interest while the dividend income (being investment or nonbusiness income) is not taxable. [Citation]." (*Willamette Industries, Inc. v. Franchise Tax Bd.* (1995) 33 Cal.App.4th 1242, 1246-1247 (*Willamette*).) The *Willamette* court relied on our Supreme Court's ruling in *Pacific Telephone*, *supra*, 7 Cal.3d at page 554, which continues to bind us here.⁷

In *Pacific Telephone*, *supra*, the Supreme Court held that the Legislature had acted reasonably by treating interest expense as the opposite of dividend income, and by requiring the offset of the one against the other. (7

⁷ The *Willamette* court ultimately concluded the interest offset rule did not apply in that case, because the dividends were business income, which is apportioned. (*Supra*, 33 Cal.App.4th. at pp. 1246, 1250.) That issue is not present here.

Cal.3d at pp. 551-552.) The high court rejected the taxpayer's argument that the offset should apply only to taxable dividend income. (*Id.* at pp. 553-556.) The court noted that the dividend income of a foreign corporation is not taxable in California, but concluded it comes within the language and logic of the offset statute, which is designed to offset interest expense against investment income.⁸ (*Id.* at pp. 552-554.) The court noted that otherwise a tax loophole would be created, and that "a foreign corporation should not be permitted to borrow money and build up its interest expense deduction and then receive tax exempt dividends on the basis of investments made with the borrowed money." (*Id.* at p. 556.)

The Supreme Court held that inclusion of nontaxable dividends in the statutory offset computation did not constitute taxation of the dividends themselves, which were reasonably used to offset the interest expense deduction. (*Pacific Telephone*, *supra*, 7 Cal.3d at p. 555.) The court noted that "California has a substantial interest in making sure that income attributable to this state is not distorted by use of the interest expense deduction, and under subsection (b), the dividends received are only taken into account to offset the interest expense deduction." (*Id.* at p. 556; see also *Lyon Metal Products, Inc. v. State Bd. of Equalization* (1997) 58 Cal.App.4th 906, 913-914 (*Lyon*) [Legislature validly closed sales tax loophole by

⁸ At the time of the *Pacific Telephone* decision, dividends of a foreign corporation were not taxable based on the doctrine of *mobilia sequuntur personam* ([movables follow the person]). (*Supra*, 7 Cal.3d. at p. 552.) Under current tax law, that doctrine has been replaced by the business/nonbusiness distinction discussed above.

adding drop shipment rule to reach transactions through out-of-state intermediaries, per Division Five of this District]; *Armour & Co. v. Wisconsin Department of Taxation* (1948) 32 N.W.2d 324, 326 [upholding similar restriction on interest deduction as constitutional].)⁹

Hunt-Wesson contends that the interest offset provision of section 24344 impermissibly taxes dividends which are constitutionally immune from taxation by California, and therefore violates the federal Due Process Clause. The Due Process Clause limits a state's power to impose a tax on an activity which is not connected with the taxing state. (*Allied-Signal, Inc. v. Director, Div. of Taxation* (1992) 504 U.S. 768, 777-778.) Thus a state may not constitutionally tax income dividends which a non-domiciliary corporation receives from subsidiary corporations having no other connection with the state. (*ASARCO, Inc. v. Idaho State Tax Comm'n* (1982) 458 U.S. 307, 327-329.)

Hunt-Wesson argues that the interest offset provision of section 24344 constitutes an indirect tax on immune

⁹ In explaining its reasons for declining to limit the coverage of subdivision (b) to taxable dividends in *Pacific Telephone*, *supra*, the Supreme Court listed as an additional factor the language of the section itself, which is phrased as a limitation on the deduction of interest expense. The court noted this view was reinforced by a letter sent from the Board to Governor Knight, before he signed the legislation, stating the provision would increase taxes on foreign corporations while reducing those of domestic corporations. (7 Cal.3d at p. 554.) Despite that potential indirect effect on foreign corporations, the Supreme Court upheld the interest offset provision, determining that it did not constitute a tax. (*Id.* at p. 555.)

income, increasing a nondomiciliary corporation's tax liability solely because it receives nontaxable dividends. Hunt-Wesson also argues that the interest offset is overbroad, because it fails to apportion interest expense, but creates a dollar-for dollar offset. If we were writing on a clean slate, these arguments might appear persuasive. In *Pacific Telephone*, *supra*, however, the California Supreme Court explicitly held that inclusion of nontaxable dividends in the statutory offset computation under section 24344 does not constitute taxation of the dividends themselves. (7 Cal.3d 544.) We defer, as we must, to that decision. (*Auto Equity Sales, Inc. v. Superior Court* (1962) 57 Cal.2d 450, 455.)

Although, as Hunt-Wesson points out, the *Pacific Telephone* case did not involve a constitutional challenge to section 24344, our Supreme Court clearly recognized the dividend income itself was not taxable in California, while upholding the interest offset provision of section 24344. (*Supra*, 7 Cal.3d at pp. 549, 552.) Hunt-Wesson's argument that *Pacific Telephone* is "an outdated, obsolete case" must be addressed to courts of superior jurisdiction to our own.¹⁰

¹⁰ Hunt-Wesson also argues the language in *Pacific Telephone* is dictum, because the taxpayer, being domiciled in California, did not contest the inclusion of the nonbusiness dividends in the interest offset provision. The taxpayer in *Pacific Telephone*, however, was a member of a unitary business (most of whose members were domiciled outside California) whose California tax liability was greater than it would have been without the application of section 24344 (*supra*, 7 Cal.3d at p. 546), because interest expense, which would otherwise have been an apportionable business expense of the entire unitary business, was assigned to non-California domiciliaries. After the tax year

Hunt-Wesson also contends the interest offset statute is unconstitutional because it discriminates against interstate commerce in violation of the Commerce Clause. First, Hunt-Wesson argues section 24344 denies the interest deduction only to non-California corporations, imposing a facially discriminatory tax which is "virtually per se invalid." This argument again collides with our Supreme Court's holding in *Pacific Telephone* that the interest offset provision does not constitute a tax on the dividends in question. Moreover, the cases on which Hunt-Wesson relies are distinguishable. In *Fulton Corp. v. Faulkner* (1996) 516 U.S. 325, for example, the intangibles tax involved was discriminatory on its face, taxing stockholders only to the degree that the issuing corporation participated in interstate commerce, and the only real issue was whether the deduction in question could be sustained as compensatory. (*Id.* at pp. 333-334.) Here, by contrast, the alleged favorable effect on local commerce is indirect and incidental. Section 24344, which is part of an overall apportioned tax scheme, does not distinguish between domestic and foreign corporations, and the same rules and logic of offsetting interest expense against investment income are applied to both. (See *Pacific Telephone*, *supra*, 7 Cal.3d at p. 558.) Deductibility of interest

there in issue, the Legislature eliminated unitary intercompany dividends from the tax base and the subsection (b) computation. (*Id.* at p. 558, fn. 11.) The Legislature did not, however, similarly adjust the treatment of non-unitary dividends, which are at issue here. We are unable to distinguish *Pacific Telephone* on any principled basis. Because we conclude the fact asserted by Hunt-Wesson does not serve to distinguish the case, *Pacific Telephone's* holding dictates the outcome here.

expense is determined not by the corporation's domicile, but by the character of the income attributable to that expense.¹¹

Thus the facial discrimination cases (with their concomitant rule of virtual per se invalidity) upon which respondent relies are not determinative. (See, e.g., *Camps Newfound/Owatonna, Inc. v. Town of Harrison* (1997) 520 U.S. 564, 572-583 [reduction of state property tax exemption for charities operated principally for benefit of non-residents was facially discriminatory and thus invalid]; *Oregon Waste Systems, Inc. v. Department of Environmental Quality of Ore.* (1994) 511 U.S. 93, 99-100 [surcharge on disposal of waste generated out of state was discriminatory on its face, triggering rule of virtual per se invalidity]; *Philadelphia v. New Jersey* (1978) 437 U.S. 617, 623-629 [New Jersey law banning waste imported from other states violated Commerce Clause].) In the absence of a directly applicable ruling by the federal Supreme Court holding unconstitutional an interest offset provision such as the one in issue here, we remain bound by *Pacific Telephone, supra*. In fact, respondent has not cited, and our research has not uncovered, any decision, federal or state, holding such a provision unconstitutional.

¹¹ The Board points out that domicile is not necessarily the operative component in determining where nonbusiness income is taxable. (See § 25125, subd. (d) [allocation of gain or loss on sale of partnership interest allocable by ratio based on original cost of partnership tangible property both in and out of state]; § 25127 [patent and copyright royalties allocable to extent utilized in state].)

Hunt-Wesson also argues section 24344 unlawfully discriminates by excluding from the interest offset computation under section 24402 dividends declared from income previously taxed by California. Hunt-Wesson contends this exclusion favors investment in California subsidiaries over investment in subsidiaries not doing business in California. Because California has previously taxed the income in question, however, we discern no unconstitutional discrimination in the state refraining from double taxation. (See *Pacific Telephone, supra*, 7 Cal.3d at p. 548, fn. 4.) Unlike *Fulton, supra*, on which respondent relies, the statute does not waive an otherwise uniform intangibles tax, based simply on the percentage of the underlying corporate income taxed by the state. Instead, it operates as part of an overall apportioned tax scheme, matching expenses with income in a manner which our Supreme Court has determined to be reasonable. (*Pacific Telephone, supra*, 7 Cal.3d at pp. 551-552, 555.)

The parties also disagree as to the application of the "internal consistency" test here. (See *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.* (1995) 514 U.S. 175, 185.) "Internal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear." (*Ibid.*) The Board contends that section 24344 does not affect respondent's overall tax liability, because if all the states in which it is taxable adopted similar provisions, respondent's taxable income in Illinois would decrease in proportion to the amount its taxable income in California would increase.

Respondent disagrees, also asserting that internal consistency is not sufficient. We need not decide this theoretical point, because the "internal consistency" standard is applicable only to taxes, and our high court has held the interest offset provision is not a tax on the income in question here. (*Pacific Telephone, supra*, 7 Cal.3d at p. 555.) Moreover, the United States Supreme Court has held that the Commerce Clause does not require absolute precision in interstate taxation, noting that the States have adopted differing rules regarding business and nonbusiness income and their attribution for apportionment purposes. (*Moorman Mfg. Co. v. Bair* (1978) 437 U.S. 267, 278-281 [rejecting argument that Commerce Clause prohibits any overlap in computation of taxable income by the States].)

Nor does the interest offset provision deprive appellants of their equal protection rights. Hunt-Wesson concedes that the only inquiry under the Equal Protection Clause is whether there is a rational relationship between the State's classification and its objective. The provision here is rationally related to California's need to close an otherwise gaping tax loophole, as explained in *Pacific Telephone, supra*. Unlike the discriminatory taxes struck down in the cases cited by Hunt-Wesson, section 24344 does not create an arbitrary classification based solely on state of domicile. (Compare *Williams v. Vermont* (1985) 472 U.S. 14, 23 [discriminatory exemption from use tax based solely on state of residence did not serve legitimate state purpose]; *Metropolitan Life Ins. Co. v. Ward* (1985) 470 U.S. 869, 878 [state may not promote domestic business by

taxing foreign corporations at a higher rate solely because of their residence].)¹²

Disposition

The judgment below is reversed. The matter is remanded to the trial court with directions to enter judgment for the Board.

Corrigan, J.

We concur:

Phelan, P.J.

Walker, J.

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¹² Respondent asserts that the legislative history of section 24344 indicates it was enacted to benefit California corporations, apparently referring to the letter from the Board to Governor Knight mentioned in *Pacific Telephone, supra*, 7 Cal.3d at p. 554. While the letter reportedly stated the provision would increase taxes on foreign corporations while reducing those on domestic corporations, the Board points out here that the letter indicates no intent to discriminate against foreign corporations but merely notes the likely consequence of section 24344 which results from plugging the tax loophole. This is a permissible subject of legislation. (See *Lyon, supra*, 58 Cal.App.4th at pp. 913-914.)

APPENDIX B

SUPERIOR COURT OF CALIFORNIA
CITY AND COUNTY OF SAN FRANCISCO
DEPARTMENT 17

HUNT-WESSON, INC., Formerly	)	No. 976628	
Known as Beatrice/Hunt Wesson,)		
a Successor by Merger with	)	PROPOSED	
Beatrice Company, Formerly	)	STATEMENT	
Known as CagSub, Inc., a	)	OF DECISION	
Successor in Interest to Beatrice	)	[C.C.P. § 632]	
Companies, Inc., Formerly Known	)		(Filed JUN-6 1997)
as Beatrice Foods Company,)		
Plaintiff,)		
v.)		
FRANCHISE TAX BOARD, an)		
Agency of the State of California,)		
Defendant.)		

Upon the oral request of both parties in accordance with Code of Civil Procedure § 632, the Court makes the following Proposed Statement of Decision:

SUMMARY

This case is brought by plaintiff Hunt-Wesson, Inc. to obtain a refund of \$2,258,020.44 in taxes and interest paid to the defendant Franchise Tax Board in its fiscal years 1980, 1981 and 1982. This amount is an alleged overpayment plus (accrued interest) resulting from the application of Revenue and Taxation Code ("Rev. & T.C.")

§ 24344(b) to plaintiff's claimed business interest expense deductions for the subject three tax years. Under Rev. & T.C. § 24344(b), the defendant disallowed a portion of plaintiff's business interest expense on a dollar-for-dollar basis with plaintiff's non-unitary subsidiary dividends for the subject years. Plaintiff concedes that Rev. & T.C. § 24344 was applied in accordance with its terms, but asserts that the statutory provisions that allow for business interest expense deductions to be offset by non-unitary dividends violate the Due Process, Commerce and Equal Protection Clauses of the United States Constitution.

FACTS

This matter was submitted upon a Joint Stipulation of Facts filed herein on February 6, 1997 ("JS"), a Supplement to Joint Statement of Facts filed herein on April 11, 1997, and a Second Supplement to Joint Statement of Facts filed herein on May 2, 1997 ("JS 2nd") which establish that:

A. Plaintiff¹ is a Delaware corporation, domiciled in Illinois (JS ¶ 1).

¹ Plaintiff Hunt-Wesson, Inc. is successor in interest to other entities, the identities of which changed over the years relevant to this action. The details of this evolution, which are specified in the Joint Statement of Facts, are not relevant to this Statement of Decision as Plaintiff is the successor in interest to the actual taxpayer of the disputed payments. For simplicity, the term "Plaintiff" shall be used throughout this Statement to refer to the taxpayer and its successor in interest.

B. During its fiscal years ending February 28 of 1980, 1981 and 1982 ("the relevant fiscal years"), plaintiff was a diversified company engaged in the food products business both within and outside of California (JS ¶ 2).

C. During the relevant fiscal years, plaintiff owned dividend paying subsidiaries, none of which were either incorporated in California or engaged in a unitary business with Plaintiff (JS ¶ 7).

D. The non-unitary subsidiaries paid plaintiff the following dividends: \$26,718,620 for fiscal year 1980; \$29,482,367 for fiscal year 1981; and \$19,022,617 for fiscal year 1982 ("the nonbusiness dividends") (JS ¶ 7).

E. All of the nonbusiness dividends were not taxable by the State of California but were taxable by the State of Illinois (JS ¶ 8).

F. During the relevant fiscal years, plaintiff incurred the following business interest expense, which it claimed as a deduction on its California Franchise Tax Returns for the respective years: \$80,490,469 for fiscal year 1980; \$55,101,503 for fiscal year 1981; and \$137,413,162 for fiscal year 1982 (JS ¶ 10).

G. Exhibit 1 to the Joint Stipulation of Facts is a list of the debt and related expenses giving rise to the foregoing claimed business interest expense deductions. No portion of these amounts was related to borrowings of the non-unitary subsidiaries which provided the above-specified dividends to plaintiff (JS ¶ 9).

H. Pursuant to Rev. & T.C § 24344(b), defendant disallowed plaintiff's business interest expense

deductions on a dollar-for-dollar basis to the extent of the dividends that plaintiff received from its non-unitary subsidiaries (JS ¶12).

I. As a result of the disallowance of business interest expense, plaintiff paid further taxes and interest thereon, the amounts of which plus accrued interest from the respective dates of payment for the relevant fiscal years are as follows: \$762,073.12 (consisting of \$139,066.00 tax plus \$623,007.12 interest accrued from May 15, 1980 through May 1, 1997) for fiscal year 1980; \$855,926.32 (consisting of \$170,486 tax plus \$232,752.71 interest paid plus \$452,687.61 interest accrued from March 15, 1989 through May 1, 1997) for fiscal year 1981; and \$640,021.00 (consisting of \$109, 640.00 tax plus \$135,803.62 interest paid plus \$394,577.38 interest accrued from July 15, 1989 through May 1, 1997) for fiscal year 1982 (JS 2nd, ¶20).

J. Plaintiff has satisfied all procedural requirements to bring this action for refund of the disputed payments (JS ¶¶21.23, 26).

ISSUES PRESENTED

Plaintiff's claim for refund is based on the argument that the provisions of Rev. & T. C. § 24344(b) which allow this state to offset business interest deductions claimed by foreign corporations on a dollar-for-dollar basis with such corporations' non-unitary dividends violate the Due Process, Commerce and/or Equal Protection Clauses of

the United States Constitution. As a threshold issue, however, it must be determined whether Pacific Telephone & Telegraph v. Franchise Tax Board, 7 Cal. 3d 544 (1972) precludes any Constitutional analysis of the subject provisions.

ANALYSIS

A. The Revenue & Taxation Code

California's Bank and Corporation Tax Law (Rev. & T.C. §§ 23001 et seq) is, in relevant part, a tax on corporations doing business in this state for the privilege of exercising corporate franchises in California. Rev. & T.C. § 23151. When a corporation does business both within and outside of California, the statutory scheme apportions "business income"² by the application of a formula which, simply put, determines the portion of such income attributable to three business factors (sales, property and payroll) which are connected with this state and taxes accordingly. Rev. & T.C. 25128. In contrast, corporate dividends are "non-business income" and are not allocated to this state unless the taxpayer is domiciled here. Rev. & T.C. § 25126. Income allocated to California under these rules is taxable by California. Rev. & T.C. § 25101.

In calculating a taxpayer's net taxable income, business interest expense is generally deducted from business income. Rev. & T.C. § 24344(a). Taxpayers must, however, offset their interest expense deductions on a dollar-for-

² "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business. Rev. & T.C. § 25120.

dollar basis with any non-business income not allocable to California. Rev. & T.C. §24344(b). This means that corporations not domiciled in California must reduce their interest deduction (in California) by the amount of their nontaxable (by California) dividend income. It is this effect that plaintiff asserts is unconstitutional.

B. Pacific Telephone & Telegraph v. Franchise Tax Board

Defendant asserts that Pacific Telephone & Telegraph v. Franchise Tax Board, supra, 7 Cal. 3d 544, is determinative of the issues in this case.

In Pacific Telephone, the issue presented was whether the phrase "interest and dividend income...not subject to allocation by formula" as an offset against interest deductions under Rev. & T.C. § 24344(b) should be interpreted to include all intercompany dividends.

The Court held that as a matter of statutory interpretation, logic and public policy, such intercompany dividends should be included in the subject phrase. The Court rejected Pacific Telephone's assertion that only *taxable* intercompany dividends be included in the offset because such phrase was not used in the statute and because other non-taxable dividends were expressly excluded from the computation under the statute, which express exclusion would be unnecessary if all nontaxable dividends were to be excluded. 7 Cal. 3d. at 554. The Court also found that logically, dividends are income whether or not taxed. Id. Finally, the Court found that its interpretation that nontaxable dividends should be offset against interest deductions was appropriate to close a potential loophole whereby a foreign corporation could

increase its borrowings to create a deduction and use the loan proceeds to buy stocks which would create nontaxable dividend income. 7 Cal. 3d at 554.

The Court did not expressly discuss any constitutional parameters for its statutory interpretation.³ The absence of any constitutionally-based holding in Pacific Telephone renders that opinion not controlling on the constitutional challenges raised here. Amwest Surety Ins. Co. v. Wilson, 11 Cal 4th 1243, 1268 (1995) ["an opinion is not authority for a proposition not therein considered," quoting Ginns v. Savage, 61 Cal. 2d 520, 524 (1964)].

C. Constitutional Analysis.

Plaintiff asserts that the offset provisions of Rev. & T.C. § 24344 (b) violate three separate clauses of the United States Constitution: the Due Process Clause, the Commerce Clause, and the Equal Protection Clause. As a general matter, every statute is clothed with a presumption of Constitutionality. County of Sonoma v. State Energy Resources Conservation Etc. Comm., 40 Cal. 3d 361, 368-70 (1985). The power of the legislature in the area of taxation is paramount, and any constitutional restriction on that power must be strictly construed against the limitation and with reference to the underlying purpose

³ It should be noted that the Court stated that the problem confronting it was largely, if not entirely, eliminated by the 1967 enactment of Rev. & T.C. §25106, which expressly dealt with the applicability of intercompany dividends under Rev. & T.C. §24344. This statutory clarification may have reduced the scope of the issues presented to the Court and might therefore explain the absence of any constitutional analysis.

of the legislation. Franchise Tax Board v. Superior Court, 212 Cal.App. 3d 1343, 1347 (1989). With these principles in mind, each of the plaintiff's challenges will be discussed separately.

1. The Due Process Clause

The Due Process Clause of the Fourteenth Amendment to the United States Constitution provides that no state shall deprive its citizens of property without due process of law. In the area of state taxation, due process protections are founded on the principle that the power to tax is exercised upon the assumption that the government is providing an equivalent value to the taxpayer in the form of protections, services or facilities. Union Refrigerator Transit Company v. Kentucky 199 U.S. 194, 202 (1905). If the taxing state government is in no position to render these protections, services or facilities to the taxpayer because the object of taxation is wholly in another state, then an attempt to tax anyway is a taking without due process of law. Id. It necessarily follows that where the objects of taxation are located in two or more states, then the due process clause requires an apportionment of tax burden so as to avoid multiple taxation without regard to the protections, services and facilities being provided by the taxing states. Standard Oil Co. v. Peck, Tax Commissioner, et al, 342 U.S. 382, 384-85 (1952). Indeed, it is this precept that forms the constitutionally permissible basis for the allocation by formula approach used in unitary tax systems such as California's. Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992) ["there must be some definite link, some minimum

connection, between a state and the person, property or transaction it seeks to tax.”]

In this case, the specific due process analysis starts with two basic precepts which both parties agree upon. First is that a state may not tax plaintiff’s nonbusiness dividends because plaintiff is a foreign domiciliary corporation and such income is only taxable in its state of domicile. JS ¶¶ 1 & 12, see ASARCO, Inc. v. Idaho State Tax Comm’n., 458 U.S. 307, 315-16 (1982). Second is that a state cannot tax indirectly that which it may not tax directly. (Plaintiff’s Proposed Statement of Decision [C.C.P. Section 632], submitted May 2, 1997, p. 6, lines 2-13; Defendant Franchise Tax Board’s Proposed Statement of Decision [Cal. Rules of Court, rule 232(c)], submitted May 2, 1997, p. 13, lines 3-8).

It is in the applicability of these two precepts to this case that the parties disagree. Plaintiff asserts that the disallowance of a deduction in the amount of the nontaxable dividends effectively increases the taxable income in California by the amount of the nontaxable dividends and thus is indirectly a tax thereon. Plaintiff contends that this is impermissible given that these dividends are not taxable in California.. Defendant argues that case authorities demonstrate that the disallowance of a deduction to the extent of certain nontaxable income is proper, especially where to do so furthers a legitimate governmental purpose. Defendant’s assertion will be discussed first.

Three of the five cases cited by defendant are federal cases dealing with United States tax statutes. None of these cases analyze the questioned statutes in terms of

the due process clause. In Denman v. Slayton 282 U.S. 414 (1931), the Court upheld federal tax statutes which excluded both income on tax exempt state obligations and interest on borrowings used to purchase them. In so doing, the Court rejected the taxpayer’s constitutional argument that the subject statutes unconstitutionally discriminated against him. Nowhere in the opinion, however, is the precise constitutional provision supposedly prohibiting such discrimination discussed. In Helvering v. Independent Life Ins. Co., 292 U.S. 371 (1934) the Court held that a federal tax statute limiting the deduction of depreciation and other expenses did not violate Art. I, § 9, cl. 4 of the U.S. Constitution, which requires that no direct tax be laid except in proportion to the census. The Court expressly stated that it was not considering any question regarding the Fifth Amendment, which is the Federal Due Process Clause. 292 U.S. at 373. Finally, in United States v. Atlas Life Insurance Co., 381 U.S. 233 (1965) the Court upheld the portion of the Federal Life Insurance Tax Act of 1959 which required an insurance company to allocate a portion of its tax exempt interest income to its tax deductible reserve funds, thereby reducing the amount of otherwise taxable income that could be shifted to the deductible reserve funds. In so doing, it rejected the taxpayer’s argument that such requirement was unconstitutional, although their exact constitutional parameters supposedly being infringed were not specified in the opinion.⁴

⁴ The Due Process Clause applicable to the Federal Government is contained in the Fifth Amendment rather than the Fourteenth Amendment. Each due process clause applies separately to its respective governmental level. Warren v.

The remaining two cases cited by the defendant do deal with state tax provisions. The first is First Nat. Bank v. Barstow Cty. Tax Assrs. 470 U.S. 583 (1985), in which the Court upheld a Georgia tax statute which limited the exclusion of tax exempt United States obligations from the calculation of a bank's net worth on a pro rata basis with the liabilities incurred to obtain them. The second case is Missouri ex rel Missouri Ins. Co. v. Gehner, 381 U.S. 233 (1930), which the Court in First Nat. Bank v. Barstow Cty. Tax Assrs., *supra*, held "has no vitality today." 470 U.S. at 591.

The cases cited by the defendant do not provide authority for the constitutional parameters governing the state tax arrangement at issue here. These cases do, however, provide a pattern of analysis which is helpful to the resolution of this case. As was summarized in First Nat. Bank v. Barstow Cty. Tax Assrs., *supra*: "In sum, ever since Gehner, each time this Court has addressed the scope of the tax exemption for Government obligations, it has concluded that the exemption need not be a total exclusion, but, instead, may be limited by charging tax exempt obligations and interest their fair share of *related* expenses and burdens." *Id.* at 593 (emphasis added). In other words, the Court has taken a symmetrical view of taxation: income and expenses are paired so that if a

Governmental National Mortgage Association 611 F.2d. 1229, 1232 (1979); see Shelly v. Kraemer, 334 U.S. 1, 12 (1948). The state fourteenth amendment due process limitations on unitary tax allocations are protections from taxation by a government which is not connected with the activity generating the earnings. Obviously this concept does not apply to a national federal government.

taxpayer need not include certain income in its taxable income, it cannot deduct expenses related to generating that non-included income from its taxable income.

Such logic is precisely what the California Supreme Court recognized in its concern over tax loopholes in Pacific Telephone:

"Although dividends received by a nondomiciliary like American are not taxable in California, it is not true that such dividends are totally unrelated to California. As pointed out above in connection with the discussion of the possible loophole, a foreign corporation should not be permitted to borrow money and build up its interest expense deduction and then receive tax exempt dividends on the basis of investments made with the borrowed money. California has a substantial interest in making sure that income attributable to this state is not distorted by the use of the interest expense deduction, and under subsection (b) [of Rev. & T.C. § 24344] the dividends received are only taken into account to offset the interest expense deduction." 7 Cal. 3d at 556.

Although not so articulated by the Court in Pacific Telephone, this analysis would seem to satisfy the constitutional due process requirements that a taxing state must have "some definite link, some minimum connection" with the property it seeks to tax. Allied Signal, Inc. v. Director, Division of Taxation, *supra*, 768 U.S. at 777. If money were borrowed in California to pay for securities generating income not taxable in California, then California would seem to have a sufficient link to the investment

transaction to close the loophole and prevent windfall deductions for interest expense.

Rev. & T.C. § 24344(b), however, is not so targeted. It disallows interest deductions on a dollar-for-dollar basis with non-taxable dividend income without regard to whether or not such interest is *related to* the dividend income. In that regard, it bears a striking similarity to the Georgia tax statute that was originally considered by the United States Supreme Court in First Nat. Bank v. Barstow Cty. Tax Assrs., *supra*, 470 U.S. 583. As originally presented to the Court, the Georgia statute might have been interpreted to prohibit the exclusion of all tax exempt United States obligations from the calculation of a bank's net worth. Upon that possibility, the Court remanded the case back to the Georgia Supreme Court in order to allow it to interpret its own state statute. On remand, the Georgia Supreme Court "sought to save the statute by construing it to allow a bank to deduct from its net worth 'the percentage of assets attributable to federal obligations'." *Id.* at 587. It was this reconsidered interpretation that was upheld by the Supreme Court. *Id.* at 596-97.

Synthesizing the foregoing, it would appear that Rev. & T.C. § 24344(b) runs afoul of defendant's authorities to the extent that it does not permit the deduction of interest expense not related to the generation of the taxpayer's nontaxable dividend income. Put differently, even given the possibility of a legitimate California state interest in closing the loophole recognized in Pacific Telephone, the statute is overly broad in that it goes far beyond such potential legitimate state purpose. This point is underscored in this case because here the parties have

stipulated that no portion of the proceeds of the loans generating the interest expense deductions herein went to any non-unitary corporation, each of which was responsible for its own borrowings. (J.S. ¶ 9). Thus, it appears that no portion of the interest expense deduction can be attributable to the generation of the interest exempt dividends.

Accordingly, Rev. & T.C. § 24344(b) results in a taking of plaintiff's property without due process of law and is thus in violation of the Fourteenth Amendment to the United States Constitution..

2. The Commerce Clause

Plaintiff's next argument is that Rev. & T.C. § 24344(b) violates the Commerce Clause of the United States Constitution. Plaintiff's argument is that the dollar-for-dollar offset against nontaxable income applies only to dividends of foreign corporations and is thus a Constitutionally impermissible burden on interstate commerce. Defendant asserts that on its face, the statute does not call for a different treatment of interest expense of foreign corporations and that at most the statute discriminates against the character of income (i.e. business vs. nonbusiness) rather than upon taxpayer domicile.

The Commerce Clause to the United States Constitution provides that "the Congress shall have the power to regulate Commerce among the several states." U.S. Const., Art. I, § 8, cl. 3. The Commerce Clause has long been interpreted to have a "negative commerce clause" that precludes the states from unjustifiably discriminating against interstate commerce. Oregon Waste Systems,

Inc. v. Department of Environmental Quality of Oregon, 511 U.S. 93, 98-99 (1993). This negative commerce clause prohibits economic protectionism, i.e., using regulatory or taxing measures to benefit in-state economic interests by burdening out-of-state competitors. Fulton Corp. v. Faulkner, ___ U.S. ___, 116 S.Ct. 848, 853 (1996).

In the area of state taxation, it is well established that a state might further a legitimate state interest with a taxing scheme that discriminates against interstate commerce, but only where the effects thereof upon interstate commerce are just incidental. City of Philadelphia et al v. New Jersey, et al, 437 U.S. 617, 6623-24 (1978). Without a legitimate state interest being furthered, however, it is clear that a state may not tax a transaction or incident more heavily simply because there is an interstate element to it; such laws are "virtually per se invalid." Fulton Corp. v. Faulkner, *supra*, at 854; Armco, Inc. v. Hardesty, Tax Commissioner of West Virginia, 467 U.S. 638, 644-46.⁵

Applying these rules to this case, it is clear that Rev. & T.C. § 24344(b) violates the negative commerce clause of the United States Constitution. The starting point in this analysis is whether the provisions requiring that interest deductions be offset against nontaxable income discriminate against foreign taxpayers. The several examples provided by the parties demonstrate that the offset provisions treat two corporations in an identical business

⁵ The "virtually per se" language reflects an exception which allows a state to require that an interstate transaction bear economic tax burdens already borne by intrastate transactions. Fulton Corp. v. Faulkner, *supra*, at 853, and cases cited therein. This exception does not apply in this case.

transaction differently based solely on their states of domicile, which difference results in increased taxes for foreign corporations. See Tables III and IV in Pacific Telephone, *supra*, at pp.552-53⁶

The defendant asserts that the *tax* in question here is nondiscriminatory. Defendant argues that if anything it is the deductions that distinguish, and those differentiate not on the domicile of the taxpayer but on whether income is nontaxable (hence must be offset against otherwise allowable interest deduction). Such linguistic analysis ignores the impact of the words being dealt with. No matter how one expresses the concept, the amount of tax on a foreign corporation under Rev. & T.C. §24344(b) will be higher than that of a domestic corporation where both have a) the same taxable business income; b) the same interest expense deductions; and c) the same dividend income. The constitutionality of such a result cannot possibly be determined by the statutory words used to create it, i.e. whether the discriminatory tax burden was caused by a "tax" or a "reduction of deduction due to nontaxable income". See, for example, Camps Newfound/Owatonna, Inc. v. Town of Harrison, et al, ___ U.S. ___, 97 Daily Journal D.A.R. 6299 (1997), where an exemption for charitable institutions from an otherwise generally applicable state property tax which excluded organizations which operated principally for the benefit of nonresidents was held to violate the negative commerce clause; Darnell &

⁶ In addition, there is some support for the view that Rev. and T.C. §24344 was expressly designed to increase taxes on foreign corporations while reducing those of domestic corporations. See Pacific Telephone at p. 554..

Son v. Memphis, 208 U.S. 113 (1908), where Tennessee tax exemptions for in state harvested logs but not out of state harvested logs was deemed an impermissible burden on interstate commerce.

The next step in the analysis would be to determine whether California was furthering a legitimate state purpose which, if identified, might justify the differentiated treatment so long as the impact on interstate commerce was merely incidental. This step does not get off the ground. As is stated in the Due Process discussion above, Rev. & T.C. §24344(b) is overbroad and as applied to this case does not further a legitimate state purpose. As such, it is irrelevant as to whether the impact on interstate commerce is incidental or not.

Therefore, Rev. & T.C. §24344(b), which discriminates against the interstate element of foreign corporation's receipt of nontaxable dividend income outside of California violates the Commerce Clause of the United States Constitution.

3. The Equal Protection Clause

Plaintiff next argues that Rev. & T.C. § 24344(b) violates the Equal Protection Clause of the United States Constitution by impermissibly creating an arbitrary and irrational classification based on the domicile of a corporate taxpayer. Defendant asserts that the language of the statute contains no classification based on domicile and, in any event, the statutory scheme is rational in that it is designed to allow deductions of only expenses which correspond to income taxable in California.

In the area of state taxation, the Equal Protection Clause⁷ precludes a state from imposing more onerous taxes or other burdens on foreign corporations than those imposed on domestic corporations, unless the discrimination between foreign and domestic corporations bears a rational relationship to a legitimate state purpose. Metropolitan Life Ins. Co. v. Ward, 470 U.S. 869, 875 (1985) [holding that the promotion of domestic industry is not a legitimate state purpose under due process analysis and rejecting Alabama's other purported interest in its higher tax rate for out of state insurers]; Williams v. Vermont, 472 U.S. 14, 23 (1985) ["A state may not treat those within its borders unequally solely on the basis of their different residences or states of incorporation."].

Applying this analysis to the present case, it is clear that Rev. & T.C. § 24344(b) violates the Equal Protection Clause. Defendant asserts that the legitimate state interest being furthered here is "to allow a deduction of only those expenses relating to an item of income which the state is not barred from taxing." Defendant Franchise Tax Board's Reply Brief, filed herein on March 13, 1997, p. 19-20. As is discussed above, however, Rev. & T.C. § 24344(b) is not so limited and precludes interest deductions to the extent of nontaxable income *irrespective of whether those deductions are related to the nontaxable income*. Since this provision applied unequally to domestic corporations and foreign corporations because only the

⁷ The Equal Protection Clause provides "...nor shall any State...deny to any person within its jurisdiction the equal protection of the laws." United States Constitution, Amendment 14, Sec. 1.

dividend income of the latter are nontaxable in California, the purported state purpose is discriminatory and not rationally related to a legitimate state purpose. As such it violates the Equal Protection Clause of the United States Constitution.⁸

CONCLUSION

Rev. & T.C. § 24344(b) violates the Due Process, Commerce and Equal Protection Clauses of the United States Constitution insofar as it allows for a dollar-for-dollar offset of otherwise deductible interest expenses with nontaxable dividend income of foreign corporate taxpayers. Accordingly, the taxes and interest at issue herein were impermissibly imposed and collected. Plaintiff is therefore entitled to Judgment for \$2,258,020.44 plus interest from May 2, 1997 as calculated under Rev. & T.C. § 19391.

Either party may on or before June 20, 1997 file and serve any objections or proposals hereto. Plaintiff shall prepare a proposed form of Judgment, submit it to the defendant for approval as to form, and present it to the Court on or before June 20, 1997.

Dated: June 6, 1997

Richard A. Kramer
Judge of the Superior Court

⁸ Defendant's further argument that the language of the statute does not discriminate against foreign corporations is rejected in light of the effect of the statute, as is discussed above.

SUPERIOR COURT OF THE STATE OF CALIFORNIA FOR THE CITY AND COUNTY OF SAN FRANCISCO

DEPARTMENT: 17

HUNT-WESSON, INC.,	CASE NO. 976628
Plaintiff(s),	CERTIFICATE OF SERVICE
v.	BY MAIL (CCP 1013a(4))
FRANCHISE TAX BOARD,	
Defendant(s).	

I, Tatsuo Maruyama, a deputy clerk of the Superior Court for the City and County of San Francisco, certify that:

- 1) I am not a party to this action;
- 2) On June 6, 1997, I served the attached;

PROPOSED STATE OF DECISION

by placing a copy thereof in a sealed envelope, addressed as follows:

CHARLES J. MOLL, III,
ESQ.
EDWIN P. ANTOLIN, ESQ.
MORRISON & FOERSTER
425 MARKET ST.
SF., CA. 94105

DAVID LEW, Deputy Atty
General
STATE OF CALIFORNIA
DEPARTMENT OF
JUSTICE
ATTORNEY GENERAL'S
OFFICE
50 FREMONT ST. STE. 300
SF., CA. 94105

and,

3) I then placed the sealed envelope in the outgoing mail at 633 Folsom Street, San Francisco, Ca. 94107 on the date indicated above for collection, attachment of required prepaid postage, and mailing on that date following standard court practices.

Dated: JUNE 6, 1997

ALAN CARLSON, Clerk

BY: Tatsuo Maruyama, Deputy
Tatsuo Maruyama
Clerk in Department 17

APPENDIX C

SECTIONS OF BANK AND CORPORATION TAXES

§ 24344. Interest

(a) Except as limited by subsection (b), there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer.

(b) If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula.

§ 24402. Dividends received by corporations

Dividends received during the income year declared from income which has been included in the measure of the taxes imposed under Chapter 2 [commencing with § 23101] or Chapter 3 [commencing with § 23501] of this part upon the taxpayer declaring the dividends.

ARTICLE 2**§ 25120. Definition of terms used in "this act"**

As used in Sections 25120 to 25139, inclusive, which shall hereafter be referred to as "this act," unless the context otherwise requires:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(d) "Nonbusiness income" means all income other than business income.

(e) "Sales" means all gross receipts of the taxpayer not allocated under Sections 25123 through 25127 of this code.

(f) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

§ 25121. Income taxable both within and without state: Allocation and apportionment

Any taxpayer having income from business activity which is taxable both within and without this state shall allocate and apportion its net income as provided in this act.

§ 25126. Interest and dividends allocable to state

Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.

§ 25128. Formula for apportioning business income to state

All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

§ 25129. Formula for determining property factor

The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the income year and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the income year.

§ 25132. Formula for determining payroll factor

The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the income year by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the income year.

§ 25134. Formula for determining sales factor

The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the income year, and the denominator of which is the total sales of the taxpayer everywhere during the income year.

APPENDIX D

[LOGO]

BILL LOCKYER
Attorney General

State of California
DEPARTMENT OF JUSTICE

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January 4, 1999

Honorable William R. McGuiness, Presiding Justice
 Honorable Carol A. Corrigan, Associate Justice and
 Honorable Herbert W. Walker, Associate Justice
 Court of Appeal of the State of California
 First Appellate District, Division Three
 303 Second Street, Suite 6005
 San Francisco, California 94107

RE: *Hunt Wesson, Inc. v. Franchise Tax Board*
 Court of Appeal No. A079969,
 Superior Court No. 976628

Dear Presiding Justice McGuiness,
 Associate Justice Corrigan
 and Associate Justice Walker:

This Court issued its unpublished opinion in this case on December 11, 1998. Appellant Franchise Tax Board of the State of California, respectfully requests that the Court's decision be published pursuant to California Rules of Court, Rule 976. The decision meets the publication criteria, because it resolves an apparent conflict in the law, it involves a legal issue of continuing public interest, and makes a significant contribution to legal

literature by reviewing the judicial history of an important tax statute.

The question answered in the *Hunt-Wesson* case is whether Revenue and Taxation Code Section 24344(b) is constitutional. The constitutionality of a section of the Revenue and Taxation Code is of great significance to taxpayers and the state. Over 40,000 corporations file returns which report their activities both within and without California. These corporations pay over 70% of the bank and corporation tax collected by California. Each of these corporations has the potential to have income which is apportioned by formula and income which is not apportioned by formula so that the amount of interest expense and the manner in which it will be taken into account is governed by Section 24344(b). Section 3.5 of Article III of the California Constitution requires the Franchise Tax Board, an administrative agency, to enforce a statute unless it is declared to be unconstitutional by an appellate court. The Franchise Tax Board has enforced, and will continue to enforce, Section 24344(b) of the California Revenue and Taxation Code in spite of claims by many corporate taxpayers that it is unconstitutional. Publication of the opinion in this case will dispel the uncertainty that exists regarding the constitutionality of Section 24344(b) for many corporations and will defer additional litigation of this question.

The California Supreme Court in *Pacific Tel. & Tel. Co. v. Franchise Tax Board* (1972) 7 Cal.3d 544, construed Section 24344(b), which speaks to the assignment and deductibility of interest expense. The California Supreme Court held that it did not constitute a tax upon dividends that California could not include within the base used to

measure the bank and corporation tax which would have been unconstitutional under decisions of the United States Supreme Court. It did not directly address the question of whether Section 24344(b) was constitutional under the Constitution of the United States.

The *Hunt-Wesson* opinion directly addresses the issue of constitutionality of Section 24344(b). There are a number of other cases, pending at the administrative level, where the question of the constitutionality of Section 24344(b) has been raised. Publication of the opinion in *Hunt-Wesson* will lead to the resolution of these cases and forestall additional litigation.

The opinion of the California Supreme Court in *Pacific Tel. & Tel. Co. v. Franchise Tax Board* was issued in 1972. A substantial period of time has passed since that opinion was issued. The years involved in *Pacific Telephone* predate the adoption of the Uniform Division of Income for Tax Purposes Act, Sections 25120 et seq. (UDITPA) of the Revenue and Taxation Code, which is now the operative law for determining whether income is subject to apportionment by formula or not. The opinion of this court in *Hunt-Wesson* provides certainty that Section 24344(b) operates in conjunction with UDITPA. In addition, the United States Supreme Court has issued a number of decisions discussing whether particular state tax statutes are discriminatory under various clauses of the United States Constitution during the intervening years. The relevance of those decisions, and in particular *Fulton Corp. v. Faulkner* (1996) 516 U.S. 325, is discussed in the opinion and provides needed guidance to both taxpayers and California's tax administrators.

Furthermore, the opinion in *Hunt-Wesson* discusses the relationship between *Fulton* and Section 24402 of the Revenue and Taxation Code. Though this question was not directly at issue in *Hunt-Wesson*, the court's discussion provides insight and guidance to both taxpayers and the Franchise Tax Board with respect to an issue that is currently being reviewed in the administrative process.

Accordingly, appellant submits that the *Hunt-Wesson* opinion meets the criteria for publication under California Rules of Court, Rules 976(b)(2), 976(b)(3) and 976(b)(4), and respectfully requests its publication.

Sincerely,

BILL LOCKYER
Attorney General

/s/ David Lew
DAVID LEW
Deputy Attorney General

APPENDIX E

First Appellate District, Division Three, No. A079969
S076104

IN THE SUPREME COURT OF CALIFORNIA

HUNT-WESSON INCORPORATED, Respondent

v. (Filed MAR. 24, 1999)

FRANCHISE TAX BOARD, Appellant

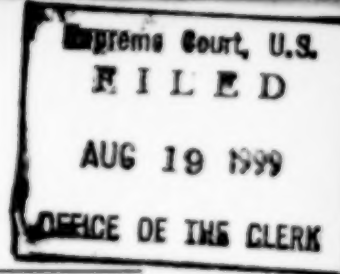
Respondent's petition for review DENIED.

The request for an order directing publication of the opinion is denied.

Kennard, J., is of the opinion the petition for review should be granted.

GEORGE
Chief Justice

3
No. 98-2043



In The
Supreme Court of the United States

—◆—
HUNT-WESSON, INC.,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

—◆—
**On Petition For Writ Of Certiorari
To The Court Of Appeal Of California
For The First Appellate District**

—◆—
**BRIEF IN OPPOSITION TO PETITION
FOR WRIT OF CERTIORARI**

—◆—
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QUESTION PRESENTED

California permits a corporation engaged in business in the State to deduct interest as an expense for the purpose of determining its California franchise tax liability. For a corporation engaged in business both in and out of California, the amount of the interest deduction is statutorily determined pursuant to Cal. Rev. & Tax. Code § 24344(b). This statute is designed to close a judicially-acknowledged tax loophole by preventing a corporation from obtaining a double tax benefit by investing its own capital in nonbusiness activities which generate dividends and interest exempt from California taxes, while concurrently avoiding California taxes by operating its business on borrowed funds, thereby generating an interest expense deduction. The statute attempts to curtail this practice by prescribing an ordering rule for correlating, or matching, a corporation's interest expense with the category of income, including nonbusiness dividend and interest income, to which it relates. Against this background, the following question is posed:

Whether the California Court of Appeal correctly concluded that the provisions of Cal. Rev. and Tax. Code § 24344(b) provide a constitutionally valid method of assigning interest expense to the business income of Hunt-Wesson under the Due Process Clause and Commerce Clause for purposes of determining its California franchise tax liability.

LIST OF PARTIES

Respondent, Franchise Tax Board, accepts petitioner Hunt-Wesson, Inc.'s version of the List of Parties as stated in its Petition for Writ of Certiorari.

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RESPONDENT'S BRIEF IN OPPOSITION

Respondent Franchise Tax Board ("Board") respectfully requests that this Court deny the Petition for Writ of Certiorari ("Petition") of petitioner Hunt-Wesson, Inc. ("Hunt-Wesson").

OPINIONS BELOW

The Board accepts Hunt-Wesson's statement of the Opinions Below as contained in its Petition and as reproduced at App. 1a-34a of the Petition.

STATEMENT OF JURISDICTION

The Board accepts Hunt-Wesson's statement of Jurisdiction as contained in its Petition.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Board accepts Hunt-Wesson's statement of the Constitutional and Statutory Provisions Involved as contained in its Petition and as reproduced at App. 35a-38a of the Petition. Additional statutory provisions are contained in App. B-1 - B-4 of the Board's Opposition.

STATEMENT OF THE CASE

This is an action for refund of California franchise taxes collected from Hunt-Wesson, a corporation engaged

in business throughout the world, including California, during fiscal years ended 1980 through 1982 ("years in issue"). Hunt-Wesson seeks a refund of \$1,523,462 and applicable interest thereon.

A. California's method of taxing multistate corporations

California imposes a franchise tax on every corporation doing business within the State. Cal. Rev. & Tax. Code § 23151. When a corporation derives its income from sources both in and out of California, its franchise tax is measured by that portion of its net business income attributable to sources within the State and the amount of nonbusiness income allocated to the State. Cal. Rev. & Tax. Code § 25101.

California taxes the business income of multistate corporations engaged in a unitary business in the State by applying a standard apportionment formula, one by which income is apportioned to California by reference to the total aggregate business income of the entire group of corporations which comprise the unitary business.¹ In apportioning the amount of a corporation's business income among the various states in which it does business, California follows the Uniform Division of Income for Tax Purposes Act (UDITPA). Cal. Rev. & Tax. Code § 25120 *et seq.* Under UDITPA, a distinction is drawn

¹ This Court has characterized a unitary business as a functionally integrated enterprise whose parts are characterized by substantial mutual interdependence and a flow of value. *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 178-179 (1983).

between business income and nonbusiness income.² Generally speaking, business income and expenses are apportioned among the various states according to the standard formula. Cal. Rev. & Tax. Code §§ 25121 & 25128. By contrast, nonbusiness income and expenses are not subject to apportionment by formula but instead are allocated entirely to a single state. Cal. Rev. & Tax. Code §§ 25123-25127. Nonbusiness income in the form of dividends and interest is generally allocable to the state where the taxpayer is commercially domiciled. *See* Cal. Rev. & Tax. Code §§ 25123 & 25126.

B. Cal. Rev. & Tax. Code § 24344(b)

Cal. Rev. & Tax. Code § 24344(b) allows for California franchise tax purposes a deduction for interest paid or accrued on indebtedness incurred by a corporation whose income is determined by the standard apportionment formula contained in section 25101.³ The statute also

² Business income is defined as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Cal. Rev. & Tax. Code § 25120(a). Nonbusiness income is defined as all income other than business income. Cal. Rev. & Tax. Code § 25120(d).

³ During the years in issue, section 24344 provided as follows:

24344. Interest.

(a) Except as limited by subsection (b), there shall be allowed as a deduction all interest paid or accrued

provides an ordering rule by which the amount of deductible interest expense to be taken against business income apportioned to California is calculated.

Section 24344(b) by its terms applies to a corporation doing business both in and out of California and whose California business income is determined by apportionment. The statute first allows such a corporation to deduct its interest expense against its business income to the extent that it has realized interest income subject to allocation by formula (i.e., business interest income). The statute then allows an additional interest expense deduction up to the amount of any remaining interest expense which exceeds interest and dividend income not subject to formula allocation (i.e., nonbusiness interest and dividend income). Lastly, the statute allows the amount, if any, of the remaining interest expense to be deducted against nonbusiness interest and dividend income (except

during the income year on indebtedness of the taxpayer.

(b) If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under Section 24402) not subject to allocation by formula.

for dividends deductible under Cal. Rev. & Tax. Code § 24402).⁴

C. Cal. Rev. & Tax. Code § 24344(b) as applied to Hunt-Wesson

Hunt-Wesson is a corporation incorporated in Delaware and domiciled in Illinois. A diversified food company producing a wide range of food and food-related products and services for worldwide markets, Hunt-Wesson is engaged in a unitary business both in California and throughout the world.

During each of the years in issue, Hunt-Wesson owned a number of dividend-paying subsidiaries, none of which was a member of Hunt-Wesson's unitary business group of corporations. These nonunitary subsidiaries paid dividends to Hunt-Wesson in an amount approximating \$27 million, \$29 million and \$19 million respectively during each of the years in issue. Hunt-Wesson reported all of these dividends on its California franchise tax returns as nonbusiness income not subject to tax by California.

Hunt-Wesson also incurred interest costs from loans in the approximate amounts of \$80 million, \$55 million and \$137 million respectively for each of the years in issue. All of the above-stated interest expense was reported as business interest expense and claimed as a

⁴ Section 24402 provides for a deduction to the recipient of dividends declared from income which has been "included in the measure of the taxes imposed . . . upon the taxpayer declaring the dividends."

deduction by Hunt-Wesson on its California franchise tax returns for the years in issue.

Following an audit, and pursuant to Cal. Rev. & Tax. Code § 24344(b), the Board allowed Hunt-Wesson to deduct its interest expense against its California business income to the full extent of its business interest income and the full extent to which the interest expense exceeded the nonbusiness dividends. The remaining interest expense was allowed as an offset against the nonbusiness dividends, which were assigned to the state of Hunt-Wesson's commercial domicile.

The Board assessed a tax deficiency against Hunt-Wesson for each of the years in issue. Hunt-Wesson paid the deficiency and filed an administrative claim for refund with the Board. The claim for refund was denied.

D. Adjudication of the federal questions in the proceedings below

Hunt-Wesson challenged the constitutionality of Cal. Rev. & Tax. Code § 24344(b) in the California Superior Court on the grounds that it violated the Due Process Clause, Commerce Clause and Equal Protection Clause of the United States Constitution. The trial court rendered judgment in favor of Hunt-Wesson on each of these grounds. App. 14a-34a of Petition.

The Board appealed. In a decision not certified for publication, the California Court of Appeal held that section 24344(b) did not violate any provision of the United States Constitution and reversed the judgment of the trial court. App. 1a-13a of Petition.

Hunt-Wesson's petition for review of the Court of Appeal's decision to the California Supreme Court was denied without comment. App. 43a of Petition.

REASONS FOR DENYING THE PETITION

This Court should deny review for several reasons. First, the California Court of Appeal's unpublished decision (App. 1a-13a of Petition) carries no precedential weight beyond the limits of this case. As such, the questions of law presented here, already judicially resolved twice by appellate courts in favor of the Board, lack sufficient national importance to warrant a third appellate review by this Court. Second, the Court of Appeal's decision is consistent with a line of decisions of this Court that a state (or other taxing jurisdiction) bears no obligation to allow a tax deduction for an expense incurred in the earning of income which that state is not permitted to tax. Finally, Cal. Rev. & Tax. Code § 24344(b) does not violate the Commerce Clause by any discrimination against taxpayers either on the basis of domicile or the extent of in-state activity. Section 24344(b) applies uniformly to domestic and foreign corporations alike without discrimination. As the Court of Appeal correctly held, the deductibility of interest expense under section 24344(b) is "determined not by the corporation's domicile, but by the character of the income attributable to that expense."⁵ App. 10a of Petition.

⁵ The issue raised in this Petition has also been raised in *F. W. Woolworth Co. and Kinney Shoe Corp. v. Franchise Tax Board*, No. 98-1967 (Petition for Writ of Certiorari filed June 7, 1999).

I. THE ISSUE PRESENTED TO THIS COURT LACKS THE SUFFICIENT NATIONAL IMPORTANCE TO WARRANT A GRANT OF CERTIORARI

Hunt-Wesson fails to state a compelling case that the constitutionality of Cal. Rev. & Tax. Code § 24344(b) is of such national urgency as to warrant review by this Court.

First, Hunt-Wesson overstates both the significance and potential ramifications of the Court of Appeal's decision for taxpayers in California and in other states of the Union. Publication of the decision was denied by both the Court of Appeal and the California Supreme Court and is not a part of the official case reports of California. As such, under California law, the decision cannot "be cited or relied on by a court of a party in any other action or proceeding. . . ." Cal. Rules of Court, Rule 977(a). Any potential impact attending to the decision as controlling legal authority thus does not extend beyond the limits of this case.

Second, Hunt-Wesson's contention that the Court of Appeal's validation of section 24344(b) will "pave the way" for other states to enact similar statutes is unfounded. The provisions of section 24344(b), as applicable to the years in issue, have been a part of California's tax landscape for over 40 years (ch. 543, p. 1600, § 1, 1957 Cal. Legis.). The California Supreme Court has previously reviewed and upheld the provisions of section 24344(b) as valid. *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 7 Cal.3d 544, 498 P.2d 1030 (1972) ("*Pacific Telephone*"). Yet, there is no evidence before this Court that any of the 49 other states currently utilizes an identical statutory provision. The belief that any state would now choose to

enact such a statute as a result of an unpublished decision carrying no precedential value is doubtful at best.

Third, the alleged impact of the Court of Appeal's decision on multistate taxpayers engaged in business in California is less pervasive than Hunt-Wesson suggests. Section 24344(b) has only limited application to those California taxpayers potentially affected by its terms. Only those multistate corporations doing business in California which incur interest expense in an amount exceeding their business interest income and concurrently realize nonbusiness income during the same tax period trigger the interest offset provisions of the statute. Where a corporation's interest expense is equal to or less than its business interest income, or where nonbusiness income is not realized, no interest is offset, and the full amount of the interest expense is deductible.

Finally, while the constitutionality of any state statute is an important issue to California, the Court of Appeal's decision resolved this question in a manner fully consistent with existing constitutional jurisprudence. This is reflected in the Court of Appeal's recommendation against publication of its decision on the grounds that it "(1) establishes no new rule of law, nor does it alter or modify an existing rule; (2) involves no legal issue of outstanding public interest; and (3) does not criticize existing law." App. A-1 of Opposition. The Court of Appeal's characterization of its decision stands in stark contrast to the selective considerations governing discretionary review on certiorari as contained in Rule 10(c). In any event, as will be shown below, a grant of certiorari would only confirm what this Court has repeatedly

stated: a taxing jurisdiction is not constitutionally prohibited from requiring a taxpayer to pay its fair share of expenses for earning income which that jurisdiction is barred from taxing.

In short, this case lacks the national significance to warrant this Court's extended attention. The Court of Appeal's decision has no binding effect on California taxpayers other than Hunt-Wesson, and legislatures in other states have demonstrated little, if any, interest in emulating California's statutory scheme. To the extent, if any, that an important question of law is presented, the Court of Appeal's decision gave full and thorough consideration to the issue and (as will be shown below) rendered judgment in a manner consistent with this Court's previous decisions and with fundamental principles of tax and constitutional law. A grant of certiorari would serve no purpose other than to require this Court to undertake a third review of a tax expense statute which two appellate courts have refused previously to declare unconstitutional.

II. THE CALIFORNIA COURT OF APPEAL'S DECISION IS CONSISTENT WITH THE SETTLED DECISIONS OF THIS COURT

A. Cal. Rev. & Tax. Code § 24344(b) Does Not Impose a State Tax on Tax-Exempt Income In Violation of the Due Process Clause

California's consideration of Hunt-Wesson's nonbusiness dividend income in the assignment of interest expense to business income under Cal. Rev. & Tax. Code § 24344(b) does not run afoul of this Court's proscription

against a state's attempt to tax constitutionally exempt dividend income received from nonunitary subsidiaries. The statute makes no attempt to tax income, either directly or indirectly, assigned outside of California. Rather, it seeks simply to ensure that a corporation engaged in business in California pays its fair share of taxes by rationally correlating interest expense to business income subject to California tax in an orderly fashion.

When a corporation engaged in business both in and out of California incurs an indebtedness and concurrently holds nonbusiness investments which generate income taxable outside of California, the question arises as to what extent, if any, the corporation should be allowed to deduct its interest costs for state tax purposes. If a full deduction is allowed, the corporation stands to gain a tax windfall by taking its full interest deduction against its business income, while at the same time shielding its nonbusiness investment income from state taxation. This inquiry stems from the judicially-recognized existence of an economic relationship between the interest costs of indebtedness and the generating of nonbusiness income, one which allows a corporation to finance its business operations on borrowed capital while at the same time earning exempt nonbusiness income by investing its own capital.

California permits a corporate taxpayer to deduct from gross income all interest paid or accrued within the taxable year on indebtedness as an expense incurred in the production of that income to determine taxable income. Cal. Rev. & Tax. Code § 24344(a). However, no deduction is allowed for expenses which are allocable to

income not subject to tax by the State. Cal. Rev. & Tax. Code § 24425.

The issue presented in this case arises where a corporation doing business in California seeks to reduce its state tax liability by claiming a deduction for interest costs which include expenses related to the production of exempt nonbusiness income. The difficulty from California's standpoint lies in determining as a practical matter the extent to which interest expense is attributable to business income as opposed to nonbusiness income not taxable by the State.

This problem stems from the basic notion that money, by its very nature, is fungible and easily subject to manipulation. For this reason, interest costs cannot be readily traced to the specific classification of income which is generated from both business and nonbusiness activities. Typically, as in this case, a corporation will claim the entire amount of its interest costs against taxable business income and allocate none to its nonbusiness income. As a result, while the nontaxable gains associated with the interest costs are not taxed at all, the interest costs themselves are deductible dollar for dollar against income that would be otherwise fully taxable but for the deduction.

To close such a loophole which essentially permits a corporation to get something for nothing, California deemed it necessary to devise a method to correlate, or match, a corporation's interest costs to the type of income to which it relates.⁶ The enactment of section 24344(b)

⁶ Hunt-Wesson erroneously claims at footnote 7 of its Petition that what remains after a corporation offsets its interest

constitutes an attempt by the California Legislature to address the complex issue of interest allocation in a rational manner.

In defining the limits to which a tax exemption may be afforded to income not subject to tax, this Court has repeatedly declared that the immunity from taxation need not be total, but may instead be limited by charging such nontaxable income its fair share of related expenses. *See Denman v. Slayton*, 282 U.S. 514 (1931) (federal tax statute permitting deduction of interest expense on indebtedness except as to indebtedness incurred to purchase or carry tax-exempt securities upheld as constitutional and reasonable to close tax loophole); *Helvering v. Independent Life Ins. Co.*, 292 U.S. 371 (1934) (federal tax provisions allowing for deduction of depreciation and expenses of buildings owned by life insurance companies but only on condition that company include in gross income the nontaxable rental value of the space which it occupied upheld as not an improper tax on the tax-exempt rental value, but rather a permissible "apportionment of expenses"); *United States v. Atlas Life Ins. Co.*, 381

expense by the amount of its interest income subject to allocation by formula under section 24344(b) constitutes "interest expense attributable to business income." Under the statute, the remaining interest expense is correlated to business income only to the extent that it exceeds nonbusiness income (interest and dividend income not subject to allocation by formula). To the extent that the interest expense is equal to or less than nonbusiness income, it is deductible against nonbusiness income. In this manner, only interest expense assigned to business income is deductible against business income for California tax purposes.

U.S. 233 (1965) (affirmed holdings in *Denman* and *Independent Life* that "the tax laws may require tax-exempt income to pay its way"); *First Nat. Bank v. Bartow Cty. Tax Assrs.*, 470 U.S. 583 (1985) (state statute limiting deduction of tax-exempt government obligations in determining bank's net worth on which tax was based upheld as constitutional).⁷

The Court of Appeal's decision upholding the constitutional validity of section 24344(b) is fully consistent with this line of authority. Similar to this Court's decisions, section 24344 is premised on the idea that a state bears no obligation to allow a deduction for an expense relating to dividend income which that state is barred from taxing. The statute attempts only to fairly correlate that portion of interest expense which is attributable to the tax-exempt income.

In *Pacific Telephone*, 7 Cal.3d at 551-52, 498 P.2d at 1036, on which the Court of Appeal's decision principally rests, the California Supreme Court correctly acknowledged the economic relationship between interest costs

⁷ Hunt-Wesson's reliance on *National Life Ins. Co. v. United States*, 277 U.S. 508 (1928), at page 18 of its Petition, to support its claim of indirect taxation is misplaced. That case involved the reduction of a reserve deduction which was "unrelated" to the receipt of nontaxable municipal bond income. By contrast, section 24344(b) is premised on the notion that interest expense is offset because it is **economically related** to the receipt of nonbusiness dividend and interest income. Furthermore, unlike the taxpayer in *National Life*, Hunt-Wesson "was not in effect required to pay more upon [its] taxable receipts than was demanded of others who enjoyed like incomes solely because [it] was the recipient of [nontaxable income]." *Denman*, 282 U.S. at 519.

and dividend income not taxable by California which section 24344(b) was designed to address. The Court observed that inasmuch as section 24344(b) applies only to a corporation that engages in business both in and out of California, both income and expenses must be apportioned to sources within the State and sources outside the State where the corporation is engaged in activities. *Id.* at 555, 498 P.2d at 1038. The Court's conclusion that section 24344(b) rationally apportions deductions to their proper income source by the measure of nontaxable income is fully consistent with this Court's decisions which permit taxpayers to be held accountable for expenses attributable to the production of such income.

Furthermore, the California Supreme Court in *Pacific Telephone* expressly rejected the notion that the inclusion of nontaxable dividends in the section 24344(b) calculation is tantamount to the indirect taxation of such dividends. *Id.* at 555, 498 P.2d at 1038. That the statute operates to increase Hunt-Wesson's California taxable income to the extent that it receives nonbusiness dividends does not mean that nontaxable income is being taxed. On the contrary, the statute simply operates to foreclose to a corporation such as Hunt-Wesson the opportunity to eliminate California taxes by deducting interest expenses economically related to its nonbusiness dividend income, on a dollar for dollar basis, against business income, thereby resulting in a double tax benefit.

That Hunt-Wesson made no direct operating loans to its nonunitary subsidiaries during the years in issue does nothing to invalidate the application of section 24344(b) to this case. This is so because even when borrowed

funds are used exclusively for business purposes, the mere act of borrowing will necessarily make available other funds which Hunt-Wesson may utilize for nonbusiness purposes. Indeed, it is at least debatable whether a corporation may properly treat borrowed money as truly borrowed for business purposes when it has funds of its own invested in nonbusiness activities which, if used, would eliminate the necessity of borrowing and thus eliminate the interest expense. Put differently, interest expense may be properly viewed as the cost of obtaining income from nonbusiness investments to the extent that the two are equivalent regardless of whether the borrowed money was or was not used for business purposes.⁸

This Court's decisions, cited above, have repeatedly declared that statutes, similar to section 24344(b), which correlate expenses between taxable income and nontaxable income in order to determine the extent to which a deduction should be allowed are constitutionally permissible. A corporation that borrows money to enable it to earn nonbusiness income through investments is not constitutionally entitled to pay less California tax than a corporation which owns no such investments. Merely because Hunt-Wesson is constitutionally protected in California from taxation of its nonbusiness income does not mean that California is barred from apportioning its

⁸ Given the fungible nature of money, it cannot be readily demonstrated that Hunt-Wesson incurred its interest expense during the years in issue exclusively for business purposes. The borrowed funds generating the interest expense inevitably supported the activities of the corporate office, which conducted activities relating to both unitary and nonunitary subsidiaries.

expenses so as to ensure that only that amount of expense attributable to taxable income is permitted to reduce taxable income.⁹ Section 24344 does nothing more than require Hunt-Wesson's nonbusiness income to pay its own way. As such, it is fully consistent with the Due Process Clause. A grant of certiorari to affirm what has long been a fundamental principle of taxation law is unwarranted.

B. Section 24344(b) Does Not Discriminate Against Interstate Commerce

California's consideration of Hunt-Wesson's nonbusiness dividend income in the measure of the interest

⁹ Hunt-Wesson's claim at footnote 14 of its Petition that nonbusiness interest expense is excluded as a deduction before section 24344(b) is applied appears to be based on its interpretation of California state tax form Schedule R-5, Form 100. Clerk's Transcript ("CT") p. 58. This form instructs the taxpayer to identify and subtract its nonbusiness interest expense prior to determining the amount of interest expense attributable to business income. However, given the rationale of section 24344(b), any nonbusiness interest expense excluded from the statutory calculation refers only to that expense which is *directly* traceable to a specific item of nonbusiness income.

In any event, nothing in the statutory provisions of section 24344(b) calls for the elimination of nonbusiness interest expense as part of the calculation of interest expense deduction. See *Pacific Telephone, supra*, at 549-550, 498 P.2d at 1034-1035. Since Hunt-Wesson's challenge is directed to the constitutionality of section 24344(b) itself, and not to the provisions of Schedule R-5, any confusion contained in this form has no bearing on the outcome of this case. The amount of tax in dispute here is unaffected by any such ambiguity, and Hunt-Wesson does not contend otherwise.

expense attributable to business income under Cal. Rev. & Tax. Code § 24344(b) furthermore does not violate the Commerce Clause by favoring in-state activity over out-of-state activity.

First, section 24344(b) does not assign interest expense to nonbusiness income taxable outside of California in all cases in which a multistate corporation receives dividends from nonunitary subsidiaries. The challenged provisions of the statute come into play only in those instances where a corporation's interest expense exceeds its business interest income. Where the corporation's interest expense does not exceed or is equal to its business interest income, a full interest expense deduction is allowed regardless of the amount of nonbusiness income realized and regardless of the corporation's state of domicile.

Second, Hunt-Wesson's claim of discrimination based on domicile is unfounded. Discrimination, for constitutional purposes, is prohibited only as to taxpayers which are similarly situated. See *General Motors v. Tracy*, 519 U.S. 278 (1997) (upholding Ohio law which imposed sales and use tax on purchases of natural gas from out-of-state companies, but not on purchases of natural gas from in-state companies, as not facially discriminatory). In this case, the constitutionally relevant basis for comparison lies not between domiciled and nondomiciled corporations, but rather between corporations that elect to borrow money while also earning nonbusiness interest and dividends not subject to California tax and corporations that borrow money without also earning such nonbusiness interest and dividends. Under section 24344(b), California strives to ensure that a corporation that invests its

own capital in nonbusiness activities while operating on borrowed funds and a corporation that operates on its own capital and owns no such nonbusiness investments are similarly situated for state tax purposes. In this manner, the amount of deductible interest expense does not discriminate against non-domiciled corporations – the amount of the interest expense assigned to nonbusiness income is the same regardless of whether the corporation is domiciled in California – but simply places the two corporations on an equal footing. Section 24344(b) seeks not to encourage in-state activity, but rather to discourage a corporation from electing to use its capital for nonbusiness purposes while operating its business on borrowed monies, thereby generating for itself a tax windfall.¹⁰

Third, even assuming that Hunt-Wesson's chosen basis for comparison were proper, no constitutionally cognizable "discrimination" exists here. Whether a state tax is discriminatory "requires an examination of the state's whole tax structure." *Washington v. United States*, 460 U.S. 536, 542 (1983). Inasmuch as section 24344(b) applies only to a corporation engaged in a unitary business both in and out of California, it is only appropriate that its constitutional validity be considered within the context of the unitary business principle of income apportionment.

As such, section 24344(b) cannot be viewed as an isolated tax expense statute, but rather as part of an

¹⁰ Alternatively, had Hunt-Wesson qualified the dividends from its nonunitary subsidiaries as business income, all of its interest expense would be attributable to business income and fully deductible in California regardless of domicile.

overall tax scheme by which Hunt-Wesson's net income is apportioned pursuant to a judicially-approved formula among all of the states in which it conducts business. As a member of a unitary business, Hunt-Wesson's taxable California income is determined by calculating the income and expenses of its entire business worldwide and then apportioning by formula a portion of that net income to the State. The apportionment of Hunt-Wesson's total net income from all sources ensures that only a fair share of its interest expense is being attributed to California.

For apportionment purposes, it is not appropriate to consider interest expense as a state-specific expense. Here, viewing Hunt-Wesson as part of a unitary group which is liable for taxes in all states in which it does business, the total tax of the group does not depend on their various states of domicile.¹¹ Just as Hunt-Wesson's revenue is derived from a unitary business and thus not confined to a single state, so too the costs of producing this revenue are also unitary in nature. Accordingly, when California attributes a share of Hunt-Wesson's interest expense as a deductible cost of a unitary business

¹¹ Unlike the statutes struck down in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996) and the other cases on which Hunt-Wesson relies, section 24344(b) is not discriminatory by its terms and does not facially distinguish between domestic and foreign corporations. Any differentiation in treatment is not the result of domicile, but of the character of the income which is attributable to the interest expense. The distinction afforded between business and nonbusiness income is one that is mandated by constitutional jurisprudence. See *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982).

under section 24344(b), the resulting net figure is a unitary one, which may legitimately be apportioned among the states by formula. See *Amerada Hess v. Director, Div. of Taxation*, N. J. Dept. of Treasury, 490 U.S. 66, 74 (1989).

In the absence of distinctive issues, the anti-discrimination principle of the Commerce Clause "has not in practice required much in addition to the requirement of fair apportionment." *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 171 (1983). Thus, the substantive provisions of a tax do not have a discriminatory effect if the tax is fairly apportioned. See *Trinova Corp. v. Michigan Treasury Dep't*, 498 U.S. 358, 384-387 (1989).

When section 24344(b) is viewed in the context of apportionment of both income and expenses, it is evident that the statute favors neither California domiciliaries nor nondomiciliaries. Section 24344(b) does not prevent a multistate corporation from recognizing the full benefit of each dollar of interest expense which it has incurred. Rather, it simply assigns that interest expense to income attributable to other states in such a manner as to more accurately reflect the true nature and source of that expense. Fair apportionment operates to limit the territorial reach of state power by requiring that the state's tax base corresponds to the taxpayer's in-state presence. Because income is fairly apportioned in California, section 24344(b) neither imports revenue nor exports burdens to other states. The assignment of interest from one

state to a more appropriate state is all that is occurring. That is not discrimination.¹²

¹² Hunt-Wesson's Commerce Clause argument is not enhanced by its claim at footnote 8 of its Petition that section 24344(b) also favors in-state over out-of-state activity by virtue of the application of section 24402. This statutory deduction is intended "to avoid double taxation at the corporate level of income which has already been subjected to California taxation in the hands of the dividend-declaring corporation." *Pacific Telephone*, 7 Cal.3d at 548, n. 4, 498 P.2d at 1034, n. 4. Inasmuch as the dividend-producing income has already been taxed in California, no advantage is afforded to California subsidiaries over foreign subsidiaries. The exemption does nothing more than compensate for the earlier taxation of the dividend-producing income by California, thereby eliminating the chance that such income might be subjected to taxation more than once.

In reality, Hunt-Wesson's complaint is directed not at section 24344(b) but rather at the provisions of section 24402. The exclusion of section 24402 dividends from the section 24344(b) calculation merely reflects the fact that interest expense relating to the production of such nontaxable dividends is denied separately as a deduction by virtue of section 24425, which proscribes the deduction of any expense allocable to income not taxable by California. See *Great Western Financial Corp. v. Franchise Tax Bd.*, 4 Cal.3d 1, 479 P.2d 993 (1971). For this reason, the amount of a corporation's interest expense which correlates to such nontaxable income, as measured by the section 24402 dividends, is properly not taken into account again for purposes of section 24344(b).

CONCLUSION

For all of the foregoing reasons, the petition for writ of certiorari should be denied.

Respectfully submitted,

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August 19, 1999

App. A-1

APPENDIX A

State of California
COURT OF APPEAL
First Appellate District
Division Four
303 Second Street, Suite 600 - South
San Francisco, CA 94107

January 8, 1998

The Honorable Ronald M. George
Supreme Court of California
Marathon Plaza, South Tower
303 Second Street, Suite 800
San Francisco, CA 94107

Re: Hunt-Wesson v. Franchise Tax Board, A079969

Dear Justice George:

We have received the enclosed letter requesting publication of our opinion, filed December 11, 1998, in the above case. A copy of our opinion is also enclosed. This court denied the request for publication. In accordance with the provisions of rule 978, California Rules of Court, the request is transmitted for your consideration.

We recommend that the request for publication be denied. The opinion (1) established no new rule of law, nor does it alter or modify an existing rule; (2) involves no legal issue of outstanding public interest; and (3) does not criticize existing law. (Cal Rules of Court, rule 976(b).)

Very truly yours,

/s/ William R. McGuiness
WILLIAM R. MCGUINESS
Presiding Justice

APPENDIX B

**RELEVANT SECTIONS OF THE CALIFORNIA
REVENUE & TAXATION CODE**

§ 24425. Items allocable to income not taxed

Any amount otherwise allowable as a deduction which is allocable to one or more classes of income not included in the measure of the tax imposed by this part, regardless of whether such income was received or accrued during the income year.

**§ 25101. Derivation from domestic and foreign sources;
measure of tax apportionment**

When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120). However, any method of apportionment shall take into account as income derived from or attributable to sources without the state, income derived from or attributable to transportation by sea or air without the state, whether or not the transportation is located in or subject to the jurisdiction of any other state, the United States or any foreign country.

If the Franchise Tax Board reapportions net income upon its examination of any return, it shall, upon the written request of the taxpayer, disclose to it the basis upon which its reapportionment has been made.

§ 25123. Allocation of nonbusiness income

Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in Sections 25124 through 25127 of this act.

§ 25124. Net rents and royalties

(a) Net rents and royalties from real property located in this state are allocable to this state.

(b) Net rent and royalties from tangible personal property are allocable to this state:

(1) If and to the extent that the property is utilized in this state, or

(2) In their entirety if the taxpayer's commercial domicile is in this state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(c) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the income year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the income year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible personal property is utilized in the

state in which the property was located at the time the rental or royalty payor obtained possession.

§ 25125. Capital gains and losses

(a) Capital gains and losses from sales of real property in this state are allocable to this state.

(b) Capital gains and losses from sales of tangible personal property are allocable to this state if:

(1) The property had a situs in this state at the time of the sale, or

(2) The taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

(c) Except in the case of the sale of a partnership interest, capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

(d) Gain or loss on the sale of a partnership interest is allocable to this state in the ratio of the original cost of partnership tangible property in the state to the original cost of partnership tangible property everywhere, determined at the time of the sale. In the event that more than 50 percent of the value of partnership's assets consist of intangibles, gain or loss from the sale of the partnership interest is allocated to this state in accordance with the sales factor of the partnership for its first full tax period immediately preceding the tax period of the partnership during which the partnership interest was sold.

§ 25126. Interest and dividends

Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.

§ 25127. Patent and copyright royalties

(a) Patent and copyright royalties are allocable to this state:

(1) If and to the extent that the patent or copyright is utilized by the payor in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this state.

(b) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

(c) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

APPENDIX C

**RELEVANT RULES OF THE CALIFORNIA
RULES OF COURT**

Rule 977. Citation of opinions

(a) [Unpublished opinions] An opinion of a Court of Appeal or an appellate department of the superior court that is not certified for publication or ordered published shall not be cited or relied on by a court or a party in any other action or proceeding except as provided in subdivision (b).

(b) [Exceptions] Such an opinion may be cited or relied on:

(1) when the opinion is relevant under the doctrines of law of the case, res judicata, or collateral estoppel; or

(2) when the opinion is relevant to a criminal or disciplinary action or proceeding because it states reasons for a decision affecting the same defendant or respondent in another such action or proceeding.

(c) [Citation procedure] A copy of any opinion citable under subdivision (b) or of a cited opinion of any court that is available only in a computer-based source of decisional law shall be furnished to the court and all parties by attaching it to the document in which it is cited, or, if the citation is to be made orally, within a reasonable time in advance of citation.

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Supreme Court, U. S.
F I L E D

AUG 31 1997

CLERK

No. 98-2043

**In The
Supreme Court of the United States**

—◆—
HUNT-WESSON, INC.,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

—◆—
**On Petition For A Writ Of Certiorari
To The Court Of Appeal Of California
For The First Appellate District**

—◆—
REPLY BRIEF FOR PETITIONER

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RULE 29.6 STATEMENT

Hunt-Wesson, Inc. is a wholly owned subsidiary of ConAgra, Inc. Its non-wholly-owned subsidiaries are ConAgra Brands, Inc. and ConAgra Limited.

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REPLY BRIEF FOR PETITIONER

Respondent makes essentially three points in its Brief in Opposition. First, the case lacks national significance because the California Court of Appeal chose not to publish its opinion. Br. Opp. 8-10. Second, the interest-offset provision can be defended as a method of “rationally correlating interest expense to business income.” *Id.* at 11. Third, the interest-offset provision does not discriminate against interstate commerce because it does not apply in all cases (*id.* at 18), domiciliary and non-domiciliary taxpayers are not similarly situated (*id.* at 18-19), the overall tax is fairly apportioned (*id.* at 19-22), and the provision was not intentionally discriminatory. *Id.* at 22 n.12.

None of these points has substance. First, respondent itself has recognized the “great significance” of this case (Pet. App. at 40a), and its eleventh-hour conversion is disingenuous, to say the least. Second, respondent’s attempt to cast the interest-offset provision as a method of “rationally correlating interest expense to business income” (Br. Opp. 11) ignores the plain language of the statute and the stipulated fact that the interest-offset applies only to “business interest expense” after the deduction of “nonbusiness interest expense.” Stip. ¶ 11, CT p. 58 (emphasis supplied). Third, respondent’s shotgun defense to petitioner’s claim of discrimination disregards this Court’s controlling Commerce Clause doctrine and fails to respond to the incontrovertible fact that the effect of the interest-offset provision favors in-state over out-of-state corporations.

In short, as we demonstrate below, an analysis of respondent’s Brief in Opposition simply reinforces the case for certiorari.

I. THIS CASE HAS PROFOUND NATIONAL SIGNIFICANCE

Respondent’s contention that this case lacks national significance (Br. Opp. 8-10) cannot be taken seriously. Respondent itself has explicitly recognized that “[t]he

question answered in the *Hunt-Wesson* case . . . is of great significance to taxpayers and the state." Pet. App. at 40a. It has acknowledged that this case potentially affects "[o]ver 40,000 corporations . . . which report their activities both within and without California" (*id.*) and which "pay over 70% of the bank and corporation tax collected by California." *Id.* And it has observed that "[e]ach of these corporations has the potential to have income which is apportioned by formula and income which is not apportioned by formula so that the amount of interest expense and the manner in which it will be taken into account is governed by Section 24344(b)." *Id.*

Furthermore, there is no merit to respondent's assertion that this case is not certworthy because the Court of Appeal rejected respondent's request that the court's opinion be published. If it were otherwise, then the state court's judgment whether to certify an opinion for publication rather than this Court's criteria governing review on certiorari (*see* United States Supreme Court Rule 10) would determine whether a petition were granted. Moreover, equating the publication of an opinion with its certworthiness would render the issue raised by this case as "capable of repetition yet evading review," *Dunn v. Blumstein*, 405 U.S. 330, 333 n.2 (1972), as courts continue to affirm respondent's position without certifying their opinions for publication. *See, e.g., F.W. Woolworth Co. v. Franchise Tax Bd.*, No. A075506, California Court of Appeal, First Appellate Dist., Div. 3 (Dec. 11, 1998) (not certified for publication), *petition for cert. filed*, June 7, 1999 (No. 98-1967).

Finally, respondent's attempt to minimize the national significance of this case is belied by the amicus briefs filed by the Tax Executives Institute (TEI) and the Committee on State Taxation (COST) urging the Court to grant *Hunt-Wesson's* petition. TEI has approximately 5,000 members representing nearly 2,800 of the leading businesses in the United States and Canada. COST has a membership of over 500 multistate corporations engaged in interstate and international commerce. The intense

interest that TEI and COST have expressed in this case, and their deep concern over its widespread implications, demonstrates the national importance of this controversy.

II. CALIFORNIA'S INTEREST-OFFSET PROVISION DOES NOT ALLOCATE INTEREST EXPENSE TO RELATED INCOME

According to respondent, this case is simply about a statute that allocates interest expense to related income, *i.e.*, to the income produced by the loans on which the interest was paid. Respondent repeats this theory throughout its brief, using different formulations. Respondent thus characterizes the interest-offset provision as a "rule for correlating or matching, a corporation's interest expense with the category of income . . . to which it relates," (Br. Opp i); as a rule "rationally correlating interest expense to business income," (*id.* at 11); as a "method to correlate, or match, a corporation's interest costs to the type of income to which it relates," (*id.* at 12); as a rule attempting "only to fairly correlate that portion of interest expense which is attributable to . . . tax-exempt income," (*id.* at 14); as a rule "premised on the notion that interest expense is offset because it is economically related to the receipt of nonbusiness dividend and interest income," (*id.* at 14 n.7); as a rule designed to address "the economic relationship between interest costs and dividend income," (*id.* at 14-15); and as a rule which "correlate[s] expenses between taxable income and nontaxable income." *Id.* at 16.

If respondent's characterization of the interest-offset provision were accurate, petitioner would not be here. Petitioner takes no issue with the widely accepted principle that interest expense should be allocated to the income that it helps produce.¹ But respondent's

¹ Indeed, petitioner acknowledges that interest expense may be allocated to the income it produces by any of a variety of

characterization of the interest-offset rule as a method for "correlating" or "matching" interest expense to related income is demonstrably false. Once the false predicate underlying respondent's argument is removed, its entire argument collapses.

First, the statute itself unequivocally requires that every dollar of net business interest expense – not just the interest expense fairly attributable to the taxpayer's nontaxable interest and dividends – be reduced by the amount of those nontaxable interest and dividends.² After allowing a deduction for business interest expense against business interest income, the statute limits the interest expense deduction to "the amount, if any, by which the balance of interest expense exceeds interest and dividend income . . . not subject to allocation by formula." Cal. Rev. & Tax. Code § 24344(b). The reduction of the interest expense deduction by the amount of the nonbusiness interest and dividend income is absolute and unconditional. There is no "matching," no "correlation," no "economic relationship," no anything; just a dollar-

accepted methods, including direct tracing or apportionment based on income or asset values. *See, e.g.*, Treas. Reg. §§ 1.163-8T(a)(3) (providing for direct tracing), 1.265-1(c) (providing for direct tracing, or apportionment based on facts and circumstances), and 1.861-9T (providing for the apportionment of interest expense to taxable and non-taxable income-producing activities and assets by an asset method or gross income method). As explained below, however, such accepted methods of interest expense allocation are a far cry from what we have here.

² As we noted in our petition, (*see* Pet. 8 n.7), California permits a taxpayer to offset its business interest expense against its "interest income subject to allocation by formula," Cal. Rev. & Tax. Code § 24344(b), *i.e.*, apportionable or "business" interest income. Hence, it is the "net" business interest expense – the interest expense attributable to business income that remains after subtracting apportionable interest income – that is at issue here.

for-dollar reduction in the otherwise permitted deduction by the amount of the nontaxable, nonbusiness income.

Second, what is clear from the plain language of the statute also is explicitly set forth in the stipulation in this case. The parties stipulated that "[b]efore the 'interest offset' computation was made starting with line 3 of Schedule R-5, nonbusiness interest expense (line 2 of Schedule R-5) was deducted from total interest expense (line 1 of Schedule R-5)." Stip. ¶ 11, CT 58. The only interest expense available for the interest-offset computation was therefore business interest expense, and that is precisely what the stipulation says: "*Thus, the remaining interest expense reported on line 3 of Schedule R-5 was business interest expense subject to the 'interest offset' computation.*" *Id.* (emphasis supplied).³

Consequently, this case does not raise the question whether California may adopt a "rule for correlating, or matching, a corporation's interest expense with the category of income . . . to which it *relates*," (Br. Opp i) (restating Question Presented) (emphasis supplied), a question that both petitioner and respondent would answer in the affirmative.⁴ Rather, it raises the question whether California may adopt a rule for allocating a corporation's interest expense to nontaxable income to which it does *not relate*. As the trial court found – and the Court of Appeal did not question this finding:

³ The stipulated facts therefore put to rest any debate over the question whether the interest-offset provision applies to nonbusiness interest expense. It does not. Accordingly, there is no need in this case to consider respondent's astonishing disavowal of its own tax return instructions, based upon its theory that "nothing in the statutory provisions of section 24344(b) calls for the elimination of nonbusiness interest expense as part of the calculation of interest expense deduction." Br. Opp. 17 n.9.

⁴ Respondent's citation of cases from this Court that stand for this proposition is therefore beside the point. Br. Opp. 13-14.

here the parties have stipulated that no portion of the proceeds of the loans generating the interest expense deductions herein went to any non-unitary corporation, each of which was responsible for its own borrowings. (J.S. ¶ 9). Thus, it appears that no portion of the interest expense deduction can be attributable to the generation of the . . . exempt dividends.

Pet. App. 26a-27a.

Third, respondent's attempt to justify the interest-offset provision on the ground that "money . . . is fungible" (Br. Opp. 12) and that "interest costs cannot be readily traced to the specific classification of income which is generated from both business and nonbusiness activities" (*id.*) is a classic non sequitur. Even if money is fungible, it does not follow that California may adopt any provision – no matter how arbitrary – to allocate interest expense between taxable and nontaxable income. In fact, the interest-offset does not even rise to the level of an arbitrary allocation provision, because, rather than allocating interest expense between taxable and nontaxable income, it simply assigns net business interest expense to nontaxable income. Moreover, respondent's position that it is too difficult to allocate interest expense to a particular category of income (*id.*) is inconsistent with California statutes, regulations, and return requirements that provide for just such allocation. *See, e.g.,* Cal. Rev. & Tax. Code § 24425 (excluding from measure of tax "[a]ny amount otherwise allowable as a deduction which is allocable to . . . income not included in the measure of the tax"); Cal. Code Regs. tit. 18, §§ 24344(c)(3), (4) & (5) (making appropriate allocation); Cal. Code Regs. tit. 18, § 25120(d) (requiring deduction to be "fairly distribute[d]" among business and nonbusiness income).

Finally, respondent's assertion that the interest-offset provision serves to close a tax loophole is unfounded. Respondent asserts that this alleged loophole arises because petitioner is "shielding its nonbusiness investment income from state taxation." Br. Opp. 11. But no

such loophole exists on the facts of this case. Rather, as stipulated by the parties, all of that nonbusiness investment income was taxable by Illinois, petitioner's state of domicile. Stip. ¶ 8, CT 57.

III. RESPONDENT'S CONTENTION THAT THE INTEREST-OFFSET PROVISION DOES NOT DISCRIMINATE AGAINST INTERSTATE COMMERCE CANNOT WITHSTAND ANALYSIS

The interest-offset provision discriminates against interstate commerce for two, independent reasons. First, it provides more favorable interest expense deductions for domiciliary than for nondomiciliary corporations, contrary to *South Cent. Bell Tel. Co. v. Alabama*, 119 S. Ct. 1180 (1999), among other decisions. Second, it allows interest expense deductions based on the extent to which a corporation's subsidiaries conduct business in California, contrary to *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), among other decisions. As set forth below, respondent's scattered responses to these claims lack merit.

1. Respondent's contention that the interest-offset provision is constitutionally tolerable because it does not apply "in all cases in which a multistate corporation receives dividends from nonunitary subsidiaries" (Br. Opp. 18) is beside the point. As the Court has observed, "[w]e need not know how unequal the Tax is before concluding that it unconstitutionally discriminates." *Maryland v. Louisiana*, 451 U.S. 725, 760 (1981). Furthermore, "[t]he volume of commerce affected measures only the extent of the discrimination; it is of no relevance to the determination whether a State has discriminated against interstate commerce." *Wyoming v. Oklahoma*, 502 U.S. 437, 455 (1992) (emphasis in original).

2. Respondent also contends that domiciliary and nondomiciliary corporations are not "similarly situated" (Br. Opp. 18) for Commerce Clause purposes and that the "constitutionally relevant basis for comparison lies not between domiciled and nondomiciled corporations but

rather between corporations that elect to borrow money while also earning nonbusiness interest and dividends not subject to California tax and corporations that borrow money without also earning such nonbusiness interest and dividends." Br. Opp. 18. The contention has no support in this Court's Commerce Clause jurisprudence.

It is true, of course, that "any notion of discrimination assumes a comparison of substantially similar entities." *General Motors Corp. v. Tracy*, 519 U.S. 278, 298 (1997). In determining whether entities are "substantially similar," this Court has considered whether the entities serve the same markets and whether removal of the supposed discriminatory burden would "serve the dormant Commerce Clause's fundamental objective of preserving a national market for competition undisturbed by preferential advantages conferred by a State upon its residents or resident competitors." *Id.* at 299. In this case, two corporations identical in every respect except for their state of domicile clearly are "substantially similar entities" for purposes of discrimination analysis under the Commerce Clause. See, e.g., *South Cent. Bell*, 119 S. Ct. 1180. Indeed, if respondent's gerrymandered definition of "substantially similar entities" could inform Commerce Clause analysis, it would invite the very type of "economic Balkanization" that the Commerce Clause was designed to prevent, *Hughes v. Oklahoma*, 441 U.S. 322, 325 (1979), by permitting states to favor in-state over out-of-state corporations under the guise of a constricted classification of "substantially similar entities."

3. There likewise is no substance to respondent's next assertion that "the substantive provisions of a tax do not have a discriminatory effect if the tax is fairly apportioned." Br. Opp. 21. This Court's cases make it clear that the fair apportionment and nondiscrimination criteria of its contemporary Commerce Clause analysis are separate and independent requirements. See, e.g., *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977) (articulating four-prong Commerce Clause test including "fair apportionment" and "nondiscrimination" requirements). Thus,

in *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388, 399 (1984), the Court observed that "'[f]airly apportioned' and 'non-discriminatory' are not synonymous terms" in striking down a fairly apportioned New York income tax that was, nevertheless, unconstitutionally discriminatory. Indeed, the Court has flatly declared that "[e]ven if a tax is fairly apportioned, it may discriminate against interstate commerce." *Amerada Hess Corp. v. Director, Div. of Taxation*, 490 U.S. 66, 75 (1989).

4. In attempting to defend the feature of the interest-offset rule permitting an interest expense deduction corresponding to the extent that a corporation's subsidiaries conduct business in a state, respondent contends that it survives Commerce Clause scrutiny because it was "intended 'to avoid double taxation at the corporate level of income which has already been subjected to California taxation in the hands of the dividend-declaring corporation.'" Br. Opp. 22 n.12 (quoting *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 7 Cal. 3d 544, 548 (1972)).⁵ This allegedly benign intent is insufficient to protect the statute's disparate treatment of corporations with in-state subsidiaries and corporations with out-of-state subsidiaries from attack under the Commerce Clause. It is well established that a determination that a state tax violates the Commerce Clause "may be made on the basis of either discriminatory purpose or discriminatory effect." *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 270 (1984) (citations omitted). The discriminatory effect of favoring investments in in-state over out-of-state corporations is incontrovertible. See *Fulton Corp.*, 516 U.S. 325.

⁵ In advancing this argument, respondent implicitly acknowledges that the interest-offset provision, in fact, operates to impose a second tax upon the nonbusiness dividends not taxable by California, thereby creating the need for the exemption. This is in clear contradiction of its earlier statement that the interest-offset provision does not result in the taxation of such dividends. Br. Opp. 10-11.

Nor does respondent advance the analysis by suggesting that "[i]nasmuch as the dividend-producing income has already been taxed in California, no advantage is afforded to California subsidiaries over foreign subsidiaries" (Br. Opp. 22 n.12) by the allowance of the interest expense deduction with respect to income from in-state subsidiaries. The observation is irrelevant to the question before the Court. The question is not whether the interest-offset provision favors the dividend-paying corporation; the question is whether it favors the dividend-receiving corporation. Plainly it does, because only dividend-receiving corporations with in-state subsidiaries are entitled to the benefit of the interest expense deduction.

CONCLUSION

The petition for a writ of certiorari should be granted.

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IN THE
Supreme Court of the United States

HUNT-WESSON, INC.,
Petitioner,

v.

FRANCHISE TAX BOARD,
Respondent.

On a Petition for a Writ of Certiorari to the
Court of Appeal of California
for the First Appellate District

BRIEF OF
TAX EXECUTIVES INSTITUTE, INC.
AS *AMICUS CURIAE*
IN SUPPORT OF PETITIONER

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No. 98-2043

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v. *Petitioner,*

FRANCHISE TAX BOARD,
Respondent.

On a Petition for a Writ of Certiorari to the
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BRIEF OF
TAX EXECUTIVES INSTITUTE, INC.
AS *AMICUS CURIAE*
IN SUPPORT OF PETITIONER

INTEREST OF AMICUS CURIAE

Pursuant to Rule 37 of the Rules of the Supreme Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae* in support of Petitioner.¹ Tax Executives Institute (hereinafter "TEI" or "the Institute") is a voluntary, nonprofit association of corporate

¹ Pursuant to Rule 37.6, *amicus* TEI states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Tax Executives Institute has received the written consents of Petitioner and Respondent to the filing of this brief; those consents have been filed with the Clerk of the Court.

and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. The Institute was organized in 1944 and currently has approximately 5,000 members who represent nearly 2,800 of the leading businesses in the United States and Canada, nearly all of which are engaged in interstate commerce.

The members of the Institute represent a cross-section of the business community in North America. The Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws throughout the Nation, to reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers, and to vindicating the due process and Commerce Clause rights of business taxpayers.

Tax Executives Institute's members have a vital interest in the resolution of this case, which involves the unconstitutional effect of the so-called interest-offset rule in section 24344 of the California Revenue and Taxation Code. Many of the companies represented by TEI are directly and adversely affected by the interest-offset rule, which reduces a company's interest expense deduction for each dollar of dividends received from nonunitary subsidiaries. Even those TEI members whose companies are not doing business in California are, almost without exception, engaged in interstate commerce. Consequently, they benefit from, and are entitled to, the positive business environment ensured by the Commerce Clause and Due Process Clause of the United States Constitution.

Because TEI members and the businesses by which they are employed will be materially affected by the Court's decision whether to review this case, the Institute has a special interest in the outcome of this case.²

² If the Court determines that review of this case is proper, *amicus* TEI submits it should also grant a writ of certiorari in

SUMMARY OF ARGUMENT

The question presented in this case is whether the State of California's system of taxation for out-of-state companies violates the Commerce Clause and Due Process Clause of the Constitution. It is well settled that a State may not tax value outside its borders. Such taxation is proscribed because the "fundamental purpose of the [Commerce] Clause is to assure that there be free trade among the several States," *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 335 (1977), and because extraterritorial taxation offends fundamental notions of due process and constitutes an "unreasonable clog on the mobility of commerce," *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 527 (1935).

Like many states, California imposes a corporate franchise tax for the privilege of doing business in the State, using an apportionment formula in respect of corporations with income from sources within and without the State. In calculating a taxpayer's net taxable income, business interest expense is generally deducted from business income. Under section 24344 of the California Revenue and Taxation Code, however, taxpayers must offset their business interest expense—on a dollar-for-dollar basis—with non-business income not allocable to the State. Thus, out-of-state corporations (such as Petitioner Hunt-Wesson) are compelled to reduce their interest deduction by the amount of their nontaxable income, *without regard to whether the interest expense is related to the nontaxable income*. It is this statute that is at issue here.

F.W. Woolworth Co. and Kinney Shoe Corporation v. Franchise Tax Board, Supreme Court Docket No. 98-1967 (petition filed on June 7, 1999), which involves the same statute and raises identical issues. (The *Woolworth* case also involves the application of the Equal Protection Clause to the interest-offset rule. U.S. CONST. amend. XIV, § 1.)

In this case, the trial court concluded that section 24344 violates the Due Process, Commerce, and Equal Protection Clauses of the Constitution. This latter decision was reversed by the Court of Appeal, First Appellate District, largely on the force of the Supreme Court of California's 1972 decision in *Pacific Tel. & Tel. Co. v. Franchise Tax Board*, 7 Cal. 3d 544 (1972). Subsequent decisions of this Court, however, unequivocally demonstrate that the State's 1972 decision cannot stand. *South Central Bell Tel. Co. v. Alabama*, 119 S. Ct. 1180 (1999); *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996); *Oregon Waste Systems, Inc. v. Department of Environmental Quality*, 511 U.S. 93 (1994).

In *Pacific Telephone*, the taxpayer challenged the California interest-offset statute as it applied to nondomiciliary corporations. In reviewing the rule, the California Supreme Court conceded that "when viewed in the light of a domiciliary corporation," the rule "does not deprive the taxpayer of any of its interest deduction, but is merely an attempt to provide how the interest expense shall be allocated as between income from operations and income from investments." 7 Cal. 3d at 551 (emphasis in original). The court also commented that the allocation of interest expense is "very favorable" to the domiciliary corporation. *Id.* As applied to out-of-state companies, however, the allocation is clearly *not* favorable. Hence, on its face, the rule violates the overarching principle of the Commerce and Due Process Clauses that an apportionment formula must, first and foremost, be fair. *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 169 (1983).

Commerce Clause jurisprudence has evolved significantly since California's decision in *Pacific Telephone*.

Nowhere has this evolution been more profound than in respect of statutory schemes that facially discriminate against out-of-state commerce. Earlier this term, in *South Central Bell*, this Court invalidated Alabama's franchise tax as facially discriminatory because it gave "domestic corporations the ability to reduce their franchise tax liability simply by reducing the par value of their stock, while it denies foreign corporations that same ability." 119 S. Ct. at 1185. Five years ago, in *Oregon Waste*, the Court similarly struck down a surcharge on the disposal of waste generated out of state, holding that the taxing scheme was virtually *per se* invalid. *Id.* Accord *Fulton Corp.*, 516 U.S. at 331.

By its very terms, the interest-offset rule at issue here violates the Commerce Clause. As the trial court observed, "No matter how one expresses the concept, the amount of tax on a foreign corporation under [the statute] will be higher than that of a domestic corporation . . ." (App. at 29a.)³ Under extant Commerce Clause jurisprudence, the California statute must therefore fall.

The law must also fall under the Due Process Clause, which requires a minimal connection between the interstate activities and the taxing State, as well as a rational relationship between the income attributed to the taxing State and the intrastate value of the corporate business. *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 772-73 (1992) (citations omitted). California does not contend that the non-business income at issue here bears any relation to Petitioner's in-state activities. Rather, the State taxes the income indirectly by requiring

³ "App." references are to the various appendices bound with the Petitioner's Petition for a Writ of Certiorari to the Court of Appeal of California for the First Appellate District in *Hunt-Wesson, Inc. v. Franchise Tax Board*, No. 98-2043 (filed June 21, 1999).

a dollar-for-dollar offset of constitutionally protected income against interest expense.

Under *Allied-Signal*, a State may tax dividend income *only* where the payee and payor of the dividend are engaged in a unitary business or the capital transaction serves an operational—rather than an investment—function. 504 U.S. at 787. The dividend income sought to be taxed here bears no relationship to Petitioner's in-state activities and thus California's covert attempt to tax it should be rejected as violative of due process.

Moreover, the State's semantics—that the interest-offset rule is not a “tax” and therefore the precedents of this Court are not controlling—cannot change the substance of the statute. It is clear that California could not tax Petitioner's dividend income directly. It is also clear that a State may not, through sleight of hand, indirectly tax constitutionally protected income.

In *Allied-Signal*, the Court validated the “necessary limit on the States' authority to tax value or income that cannot in fairness be attributed to the taxpayer's activities within the State.” 504 U.S. at 780. The court below observed in this case, “If we were writing on a clean slate, these arguments [against the interest-offset rule] might appear persuasive.” (App. at 8a.) This Court can provide that clean slate by striking down the interest-offset rule because it violates the Due Process Clause of the Constitution.

For the foregoing reasons, the Court should grant the petition for a writ of certiorari and reverse the decision below.

ARGUMENT

I.

Under the Commerce and Due Process Clauses of the Constitution,⁴ a State may not tax value outside its borders. *E.g.*, *Connecticut General Life Ins. Co. v. Johnson*, 303 U.S. 77, 80-81 (1938). Such taxation is proscribed because the “fundamental purpose of the [Commerce] Clause is to assure that there be free trade among the several States,” *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 335 (1977), and because extra-territorial taxation offends fundamental notions of due process and constitutes an “unreasonable clog on the mobility of commerce,” *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 527 (1935).

This Court has rightly observed that dividing income among the several States resembles “slicing a shadow.” *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 192 (1983).⁵ Absolute consistency among taxing authorities “may just be too much to ask,” *id.*, but there are constitutional limits on a State's use of an apportionment

⁴ U.S. CONST. art. I, § 8, cl. 3 (Commerce Clause); U.S. CONST. amend. XIV, § 1 (Due Process Clause).

⁵ The unitary business principle calculates the local tax base by first defining the scope of the unitary business of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of the unitary business between the taxing jurisdiction and the rest of the world based on a formula “taking into account objective measures of the corporation's activities within and without the jurisdiction.” *Container Corp.*, 463 U.S. at 165. Although the terms “allocation” and “apportionment” are often used interchangeably in respect of the division of income among various jurisdictions, “allocation” properly refers to the “attribution of a particular type of income to a designated state, [and] ‘apportionment’ refers to the division of the tax base by formula.” JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION I: CORPORATE INCOME AND FRANCHISE TAXES* ¶ 9.01 (3d ed. 1998).

formula, especially in respect of income derived from foreign commerce.⁶ In other words, a balance must be struck between the State's need for revenue and the taxpayer's legitimate right to protection from overreaching taxing authorities. It is for this Court to ensure that the balance is a reasonable one. *See Boston Stock Exchange*, 429 U.S. at 329 (the Court has a duty "to make the delicate adjustment between the national interest in free and open trade and the legitimate interest of the individual States in exercising their taxing powers"). If the State has not "given anything for which it can ask return" in respect of the person, property, or transaction it seeks to tax, *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940), the Commerce and Due Process Clauses operate as a constitutional brake upon the State's raw power to tax.

The question presented here is whether the State of California's system of taxation for out-of-state companies violates the Commerce Clause and Due Process Clause of the Constitution. Like many states, California imposes a corporate franchise tax for the privilege of doing business in the State, which is based on the net income derived from or attributable to sources within the State. CAL. REV. & TAX CODE §§ 23151 & 25101 (West 1992). Consistent with the constitutional requirements for corporations doing business both inside and outside the State, taxability of income turns first on the unitary business principle which allocates income to the State—*i.e.*, on whether the out-of-state item sought to be taxed is "unitary" with, or functionally related to, the taxpayer's

⁶ In evaluating challenges to state taxing schemes, the Court examines the practical effect of a challenged tax to determine whether it "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

in-state activities. The amount of operating income earned in California is then determined by calculating the net operating income of the unitary business and apportioning part of it to California by use of a formula.⁷ California uses the apportionment formula set forth in the Uniform Division of Income for Tax Purposes Act (UDITPA), which compares (i) the taxpayer's property, payroll, and sales (receipts) within the taxing State to (ii) the taxpayer's total property, payroll, and sales. CAL. REV. & TAX CODE § 25128 (West 1992) (App. at 7a); UDITPA, §§ 9-17. "Non-business income"—such as dividends derived from an unrelated business activity—is not allocated to the State (and thus is not apportioned to the State) unless the corporation is domiciled there. CAL. REV. & TAX CODE § 25126 (West 1992) (App. at 37a).

In calculating a taxpayer's net taxable income, business interest expense is generally deducted from business income. CAL. REV. & TAX CODE § 24344(a) (West 1992) (App. at 35a). Under California law, however, taxpayers must offset their business interest expense—on a dollar-for-dollar basis—with non-business income not allocable to the State. CAL. REV. & TAX CODE § 24344(b) (West 1992) (App. at 35a). Thus, out-of-state corporations (such as Petitioner Hunt-Wesson) are compelled to reduce their interest deduction by the amount of their non-taxable income, *without regard to whether the interest expense is related to the nontaxable income*. It is this

⁷ The formulary apportionment of income by a State has been recognized by this Court as a valid means of taxation. *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 460 (1959) ("the entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs").

statute—which increases Petitioner's California tax liability—that is at issue here.

In this case, the trial court concluded on the merits that section 24344 violates the Due Process, Commerce, and Equal Protection Clauses of the Constitution. This latter decision was reversed by the Court of Appeal, First Appellate District, largely on the force of the Supreme Court of California's 1972 decision in *Pacific Tel. & Tel. Co. v. Franchise Tax Board*, 7 Cal. 3d 544 (1972). As explained by the Court of Appeal:

Hunt-Wesson contends that the interest offset provision of section 24344 impermissibly taxes dividends which are constitutionally immune from taxation by California, and therefore violates the federal Due Process Clause. The Due Process Clause limits a state's power to impose a tax on an activity which is not connected with the taxing state. Thus, a state may not constitutionally tax income [from] dividends which a nondomiciliary corporation receives from subsidiary corporations having no other connection with the state.

Hunt-Wesson argues that the interest offset provision of section 24344 constitutes an indirect tax on immune income, increasing a nondomiciliary corporation's tax liability solely because it receives nontaxable dividends. Hunt-Wesson also argues that the interest offset [rule] is overbroad, because it fails to apportion interest expense, but creates a dollar-for-dollar offset. If we were writing on a clean slate, these arguments might appear persuasive. In *Pacific Telephone*, however, the California Supreme Court explicitly held that inclusion of nontaxable dividends in the statutory offset computation under section 24344 does not constitute taxation of the dividends themselves.

(App. at 7a-8a (citations omitted).) The Court of Appeal reached a similar conclusion in respect of Petitioner's argument that the interest-offset rule violates the Commerce Clause; the court essentially held that the *Pacific Telephone* decision compelled it to sustain the statute. (App. at 9a-10a.) The California Supreme Court subsequently refused to review the case. (App. at 43a.)

The Court of Appeal's decision flows from the principle of *stare decisis*—reliance on the *Pacific Telephone* decision. Subsequent decisions of this Court, however, unequivocally demonstrate that the 1972 decision of the California Supreme Court cannot stand. *South Central Bell Tel. Co. v. Alabama*, 119 S. Ct. 1180 (1999); *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996); *Oregon Waste Systems, Inc. v. Department of Environmental Quality*, 511 U.S. 93 (1994).

II.

The Commerce Clause of the Constitution provides that "Congress shall have Power . . . [t]o regulate Commerce . . . among the several States. . . ." U.S. CONST. art. I, § 8, cl. 3. The clause not only provides Congress with broad regulatory powers, but also embodies a negative command forbidding States from discriminating against interstate commerce. *Oregon Waste*, 511 U.S. at 98. Its fundamental purpose "is to assure that there be free trade among the several States." *Boston Stock Exchange*, 429 U.S. at 335. To effectuate this purpose, a state taxing scheme will be invalidated if it imposes a higher tax burden on foreign corporations than on domestic corporations engaged in comparable activity. *Id.* at 329 ("[p]ermitting the individual States to enact laws that favor local enterprises at the expense of out-of-state businesses 'would invite a multiplication of preferential trade areas destructive' of the free trade which the Clause

protects" [citations omitted]); see *Maryland v. Louisiana*, 451 U.S. 725, 754 (1981); *Helliburton Oil Well Cementing Co. v. Reilly*, 373 U.S. 64, 72-74 (1963). Justifications for discriminatory restrictions on commerce must pass the strictest scrutiny. *Oregon Waste*, 511 U.S. at 101.

In this case, the Court of Appeal felt bound by a 1972 decision of the California Supreme Court upholding the interest-offset provision. (App. at 1a.) In *Pacific Telephone*, the taxpayer challenged the California interest-offset statute as it applied to nondomiciliary corporations. In reviewing the rule, the California Supreme Court acknowledged its discriminatory effect on non-residents. Specifically, the State court conceded that "when viewed in the light of a domiciliary corporation," the rule "does not deprive the taxpayer of any of its interest deduction but is merely an attempt to provide how the interest expense shall be allocated as between income from operations and income from investments." 7 Cal. 3d at 551 (emphasis in original). The court also commented that the allocation of interest expense is "very favorable" to the domiciliary corporation. *Id.* As applied to out-of-state companies, however, the allocation is clearly *not* favorable—a fact known to the State when the interest-offset rule was enacted. *Id.* at 554 (citing a letter by the Franchise Tax Board to the Governor that the rule will "increase taxes on foreign corporations while reducing those of domestic corporations").⁸ Hence, on its face, the rule violates the overarching principle of the Commerce and Due Process Clauses that an apportionment formula must, first and foremost, be fair. *Container Corp.*, 463 U.S. at 169.

Commerce Clause jurisprudence has evolved significantly since California's decision in *Pacific Telephone*.

⁸ The constitutional aspects of the statute were apparently not challenged in *Pacific Telephone*.

Nowhere has this evolution been more profound than in respect of statutory schemes that facially discriminate against out-of-state commerce. Earlier this term, in *South Central Bell*, this Court invalidated Alabama's franchise tax as facially discriminatory because it gave "domestic corporations the ability to reduce their franchise tax liability simply by reducing the par value of their stock, while it denies foreign corporations that same ability." 119 S. Ct. at 1185. Five years ago, in *Oregon Waste*, the Court similarly struck down a surcharge on the disposal of waste generated out of state, holding that it impermissibly discriminated against interstate commerce because it provided "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." 511 U.S. at 99. Indeed, the Court held that such a scheme was virtually *per se* invalid. *Id.* *Accord Fulton Corp.*, 516 U.S. at 331 (quoting the "virtually *per se* invalid" language of *Oregon Waste* in striking down an intangibles tax that was discriminatory on its face).⁹

By its very terms, therefore, the rule violates the Commerce Clause. As the trial court observed in its principled decision, "[T]he offset provisions treat two corporations in an identical business transaction differently based solely on their state of domicile, which difference results in increased taxes for foreign corporations." (App. at 28a-

⁹ Several other decisions of this Court since *Pacific Telephone* also undermine that decision's continuing vitality. See *Camps Newfoundland/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997) (reduction of state property tax exemption for charities operated principally for the benefit of nonresidents is facially discriminatory and thus invalid); *Philadelphia v. New Jersey*, 437 U.S. 617 (1978) (New Jersey law banning waste imported from other States violates the Commerce Clause).

29a.) Under extant Commerce Clause jurisprudence, the California statute must fall.

III.

The Constitution sets a limit on the power of a single State to tax the multistate income of a nondomiciliary corporation. A minimal connection between the interstate activities and the taxing State is required, as is a rational relationship between the income attributed to the taxing State and the intrastate value of the corporate business. *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 772-73 (1992) (citations omitted); *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 328 (1982). The Due Process Clause requires that "there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax." *Allied-Signal*, 504 U.S. at 778. In other words, "[o]ne may not be subjected to greater burdens upon his taxable property solely because he owns some that is free." *National Life Ins. Co. v. United States*, 277 U.S. 508, 519 (1928).

California does not contend that the non-business income at issue here bears any relation to Petitioner's in-state activities. (App. at 16a.) Rather, the State taxes the income indirectly by requiring a dollar-for-dollar offset of constitutionally protected income against interest expense. See *Willamette Indus., Inc. v. Franchise Tax Board*, 39 Cal. Rptr. 2d 757, 760-61 (Ct. App. 1995) (the tax is "exactly the same amount" whether nontaxable dividends are treated as taxable income or are applied against interest expense). Such a taxing scheme cannot withstand scrutiny.

Under *Allied-Signal*, a State may tax dividend income only where the payee and payor of the dividend are engaged in a unitary business or the capital transaction

serves an operational—rather than an investment—function. 504 U.S. at 787. Here, the State seeks to rationalize its taxation of dividend income by claiming it is merely closing a so-called loophole, *i.e.*, that a foreign corporation should not be permitted to borrow money and build up its interest expense deduction and then receive tax-exempt dividends on the basis of investments made with the borrowed money. *Pacific Telephone*, 7 Cal. 3d at 554. A suspiciously similar argument was advanced by the State of New Jersey in the *Allied-Signal* case. There, in seeking the repudiation of the unitary business principle, the State argued that multistate corporations regard all their holdings as asset pools and therefore any distinction between operational and investment assets is artificial and should be ignored. 504 U.S. at 784-85. The Court wisely rejected this strained contention, noting instead that the relevant inquiry must focus on "the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State." *Id.* at 785. The dividend income sought to be taxed here bears no relationship to Petitioner's in-state activities and thus California's covert attempt to tax it should be rejected as violative of due process.

Moreover, the State's semantics—that the interest-offset rule is not a "tax" and therefore the precedents of this Court are not controlling—cannot change the substance of the statute. It is clear that California could not tax Petitioner's dividend income directly. *ASARCO*, 458 U.S. at 327-29. It is also clear that a State may not, through sleight of hand, indirectly tax constitutionally protected income. *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388, 404-05 (1984) (it is irrelevant that a State discriminates against business carried on outside the State by disallowing a tax credit rather than by imposing a higher tax); *National Life Ins. Co.*, 277 U.S. at 520 ("What

remains after subtracting all allowances is the thing really taxed."). "The fact that a tax ostensibly laid upon a taxable subject is to be measured by the value of a non-taxable subject at once suggests the probability that it was the latter rather than the former that the law-maker sought to reach." *The Macallen Co. v. Massachusetts*, 279 U.S. 620, 629 (1929). Formal distinctions lacking in economic substance have no constitutional significance. *Westinghouse Electric Corp.*, 466 U.S. at 405. In other words, "[a] tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes." *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 374 (1991) (citation omitted). *Cf. Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271, 282-83 (1924) (States' efforts to tax income from non-unitary entities is "a mere effort to reach profits earned elsewhere under the guise of legitimate taxation").

In *Allied-Signal*, the Court validated the "necessary limit on the States' authority to tax value or income that cannot in fairness be attributed to the taxpayer's activities within the State." 504 U.S. at 780. This Court "act[s] as a defense against state taxes which, whether by design or inadvertence, . . . attempt to capture tax revenues that, under the theory of the tax, belong of right to other jurisdictions." *Trinova Corp.*, 498 U.S. at 386. California's attempt to reach Petitioner's nontaxable income by reducing its interest expense has the same effect as a direct tax on that income and cannot in fairness be sustained. The Court of Appeal observed, "If we were writing on a clean slate, these arguments might appear persuasive." (App. at 8a.) This Court can provide that clean slate by striking down the interest-offset rule because it violates the Due Process Clause of the Constitution.

CONCLUSION

For the foregoing reasons, the Court should grant the petition for a writ of certiorari and reverse the decision below.

Respectfully submitted,

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CLERK OF THE COURT

IN THE
Supreme Court of the United States

HUNT-WESSON, INC.,

v.

Petitioner,

FRANCHISE TAX BOARD,

Respondent.

On Petition for a Writ of Certiorari to the
Court of Appeal of California
for the First Appellate District

**BRIEF OF AMICUS CURIAE
COMMITTEE ON STATE TAXATION
IN SUPPORT OF PETITIONER**

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BRIEF OF *AMICUS CURIAE*
COMMITTEE ON STATE TAXATION
IN SUPPORT OF PETITIONER

INTRODUCTORY STATEMENT

This brief is submitted by the Committee On State Taxation (COST) as *amicus curiae* in support of the petitioner in the above captioned matter.¹ COST is a non-profit trade association that was organized in 1969 as an advisory committee to the Council of State Chambers of Commerce. COST, which was separately incorporated on January 1, 1992, has a membership of over 500 multi-

¹ No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Written consents of the petitioner and respondent have been obtained and filed with the Clerk of the Court.

state corporations engaged in interstate and international commerce. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities.

INTEREST OF THE *AMICUS CURIAE*

Nearly all of COST's members are engaged in business in California, and thus have a particular interest in the ultimate resolution of the tax treatment afforded multi-state business in California. The California tax provision at issue in this case unconstitutionally discriminates against many COST member companies, and expands the reach of the California tax base beyond what is constitutionally permitted. Further, COST is concerned with unconstitutional state tax treatment generally and the continued existence of overreaching and discriminatory state taxes despite the United States Supreme Court's decisions striking down tax provisions that violate constitutional limitations. Therefore, COST has an interest in this case.

SUMMARY OF ARGUMENT

Cal. Rev. & Tax Code section 24344 (the "interest offset" provision) increases the amount of California taxable income of any corporate taxpayer domiciled outside the State which receives constitutionally exempt dividend income from nonunitary corporations and incurs otherwise deductible interest expense. This is done by denying an otherwise allowable deduction dollar for dollar by the amount of income California concededly does not have the right to tax. This blatant attempt to tax extraterritorial values violates both the Due Process and Commerce Clauses. Further, in two instances the interest offset rule discriminates against interstate commerce. First, companies domiciled in California receive a larger interest expense deduction than otherwise available without the in-

terest offset provision while those domiciled outside the State are denied any interest expense deduction. Second, taxpayers that receive dividends from in-state companies receive a larger interest expense than taxpayers that receive dividends from out-of-state companies.

Because the interest offset provision violates at least two United States Constitutional limitations on state taxation, COST urges this Court to grant the petition for the writ of *certiorari*. If review is denied, California taxpayers will continue to be subjected to a tax provision that conflicts with well established constitutional principles. Worse yet, other States will be encouraged to follow California's path and use expense disallowance as a means to tax income they are constitutionally prohibited from taxing.

ARGUMENT

I. APPLICATION OF CALIFORNIA'S INTEREST OFFSET PROVISION RESULTS IN THE IMPOSITION OF A FACIALLY DISCRIMINATORY TAX ON INCOME EARNED BY NONDOMICILIARY CORPORATIONS IN VIOLATION OF THE COMMERCE CLAUSE.

The interest offset provision reduces the amount of interest expense that the Petitioner could have deducted on its California tax return. First, the provision allowed the Petitioner to deduct an amount of interest expense equal to its taxable interest income. Next, the Petitioner was required to offset—and not deduct—interest expense by an amount equal to its non-taxable dividend income (the interest offset amount).² Because the Petitioner received substantial amounts of non-taxable dividend income, it was prevented by virtue of the interest offset

² The interest offset provision also requires taxpayers to reduce interest expense by the amount of nonbusiness interest income. Cal. Rev. & Tax Code section 24344(b). Any interest expense that exceeds the interest offset amount is deductible. *Id.*

provision from deducting substantial amounts of interest expense.

The interest offset provision results in two instances of discrimination in violation of the Commerce Clause.³ The first instance of discrimination arises because of California's treatment of dividend income. Under California law, dividends received by a corporation are taxable by the State of the recipient's commercial domicile. Cal. Rev. & Tax Code section 25126. California domiciliaries generally situs dividends to California whereas non-California domiciliaries situs dividends outside the State. Because the interest offset provision requires taxpayers to pair off interest expense with dividend income, California taxpayers receive a benefit in that their in-state dividend income is reduced by interest expense. Thus, they utilize one-hundred percent of their interest expense deduction to reduce California taxable income. However, companies domiciled outside of California are burdened because they are required to offset their out-of-state dividend income with otherwise deductible interest expense. These non-California domiciliaries receive no benefit related to the interest offset amount. Thus, companies domiciled outside the State must reduce a tax deduction based on the amount of their nonbusiness income—which plainly has no connection to California. The differential treatment afforded in-state and out-of-state corporations violates the Commerce Clause of the United States Constitution.

This Court has noted on numerous occasions the constitutional prohibition of favoring in-state over out-of-state commerce. It is well settled that imposing a tax on interstate commerce that provides a direct commercial advan-

³ The Commerce Clause of the United States Constitution, U.S. Const. art. I, section 8, cl. 3, provides: "The Congress shall have the Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian tribes."

tage to local businesses runs afoul of Commerce Clause limitations. *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318, 335 (1976). The Court has an extremely low tolerance for discriminatory state taxation: "Under our cases, unless one of several narrow bases of justification is shown, see *Oregon Waste [Systems, Inc. v. Department of Environmental Quality of Oregon]*, 511 U.S. 93 (1994)], actual discrimination, wherever it is found, is impermissible, and the magnitude and scope of the discrimination have no bearing on the determinative question whether discrimination has occurred." *Associated Industries of Missouri v. Lohman*, 511 U.S. 641, 649 (1994). Thus, "State laws discriminating against interstate commerce on their face are 'virtually per se invalid.'" *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996). And, this Court has "never recognized a 'de minimis' defense to a charge of discriminatory taxation under the Commerce Clause." *Id.* at n. 3. at 333.

In determining whether a discriminatory tax comports with Commerce Clause requirements, the discriminatory tax must pass the "strictest scrutiny." *Oregon Waste Systems, Inc. v. Department of Environmental Quality of Oregon*, 511 U.S. 93, 101 (1994) (quoting *Hughes v. Oklahoma*, 441 U.S. 322, 337 (1979)). This burden is so substantial that the "facial discrimination by itself may be a fatal defect." *Oregon Waste*, 511 U.S. at 101, (quoting *Hughes*, 441 U.S. at 337).

As noted above, the interest offset provision allows in-state domiciliaries to receive the full benefit of an interest deduction while limiting the benefit of the deduction to out-of-state domiciliaries. This disparate treatment between in-state and out-of-state taxpayers unquestionably constitutes facial discrimination against interstate commerce which cannot stand this Court's strict scrutiny.

The second instance of discrimination arises as a result of an exclusion to the interest offset provision. The interest offset amount excludes "dividends deductible under the provisions of Section 24402." Cal. Rev. & Tax Code section 24344. This exclusion relates to dividends paid by corporations earning income within California.⁴ These dividends, which are at least partially derived from California source income, are not included in the interest offset amount and therefore produce a larger interest expense deduction (*i.e.*, a tax benefit). Thus, the amount of a taxpayer's interest expense deduction is affected by the California taxability of its dividend payor. If the dividend payor is subject to California tax (and meets the requirements of section 24402), then the recipient of the dividend will receive a benefit in the form of a reduced interest offset amount. If the dividend payor is not subject to California tax, then the recipient will not receive the benefit of a reduced interest offset amount. The tax benefit associated with the taxability of dividend payors is nearly identical to the in-state benefits this Court struck down in *Fulton Corp. v. Faulkner*, 516 U.S. 325, 333 (1996) and *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388 (1984).

In *Fulton*, a North Carolina intangibles tax that was imposed on stock to the extent that its issuing corporation participated in interstate commerce was found to violate the Commerce Clause. The Court held that "a regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domes-

⁴ If the dividends were paid out of California source income then the dividends are not taxed and the interest expense is deductible. Cal. Rev. & Tax Code §§ 24402 and 24344. Pursuant to section 24402, a dividend payee that owns more than 50% of the stock of the payor and the income out of which the dividend is paid was exposed to California tax, then the dividend is accorded a dividends received deduction of 100% of the dividend amount.

tic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce." Thus, a state tax that encourages in-state investment versus out-of-state investment violates the Commerce Clause. The California tax regime has an identical effect on interstate commerce: the reduction in the offset amount favors domestic corporations over their foreign competitors, and "[t]here is no doubt that this tax regime facially discriminates against interstate commerce." *Fulton*, 516 U.S. at 333. As in *Fulton*, California's preferential treatment of in-state entities cannot pass this Court's strict Commerce Clause scrutiny.

In *Westinghouse*, New York provided a tax credit that was premised on the amount of gross receipts from exports shipped from New York. The credit had the effect of "treating differently parent corporations that are situated in all respects except for the percentage of . . . shipping activities conducted from New York." *Westinghouse*, 466 U.S. at 400. Thus, the *Westinghouse* Court noted that the New York taxing scheme provides an incentive for in-state business activity and a penalty for out-of-state business activity. An examination of the provision led to the unavoidable conclusion that the credit is awarded in a discriminatory manner in violation of the Commerce Clause. The exclusion from the interest offset amount is remarkably similar to the credit at issue in *Westinghouse*. The interest offset amount is determined based on the dividend payor's taxability in California in an identical fashion as the New York tax credit.

In analyzing the constitutionality of the interest offset provision, the California Court of Appeals determined that denying the petitioner's interest expense deductions

on a dollar for dollar basis by the amount of its non-taxable dividends did not constitute taxation of the dividends themselves. Further, the California court concluded that the benefit to in-state taxpayers is "indirect and incidental."

Neither of the California court's rationales are supportable. This Court has determined "[t]hat the tax discrimination comes in the form of a deprivation of a generally available tax benefit, rather than a specific penalty on the activity itself, is of no moment," *Camps Newfound/Owatonna, Inc. v. Harrison*, 117 S. Ct. 1590, 1599 (1997) and "[t]he commerce clause forbids discrimination, whether forthright or ingenious." *Best and Co. v. Maxwell*, 311 U.S. 454, 455 (1940). Thus, disallowing a tax benefit, such as a tax deduction, to non-domiciliaries is analyzed for Commerce Clause purposes in the same manner as the imposition of an additional tax cost imposed on non-domiciliaries. Neither is constitutional. The United States Supreme Court stated over twenty years ago that this type of discriminatory taxation "forecloses a tax neutral decision and creates both an advantage for the [taxpayer] in [California] and a discriminatory burden on commerce to its sister states." *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318, 331 (1976).

The California court refused to overturn the interest offset provision "in the absence of a *directly applicable ruling* by the federal Supreme Court holding unconstitutional an interest offset provision such as the one at issue here." As noted above, this Court has rendered numerous decisions overturning state tax provisions that favor in-state versus out-of-state taxpayers. This is merely another transparent attempt by a State to save an unconstitutional tax by constraining this Court's case law to the narrow facts before it. Granting the petition for

certiorari will prevent California from discriminating against out-of-state companies and send a clear message to sister States that this type of taxation will not be tolerated.

II. THE INTEREST OFFSET PROVISION TAXES INCOME THAT HAS NO CONNECTION WITH CALIFORNIA IN VIOLATION OF THE DUE PROCESS AND COMMERCE CLAUSES.

By reducing a tax benefit (*i.e.*, a deduction) by the amount of income that California is prevented from taxing generates the same result as taxing the non-California income directly. "The principle that a State may not tax value earned outside its borders rests on the fundamental requirement of both the Due Process and Commerce Clauses that there be 'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.'" *Allied Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 777 (1992) citing *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-45 (1954).

This Court has noted on several occasions that States may not tax dividends earned from non-unitary subsidiaries. In *ASARCO, Inc. v. Idaho State Tax Comm'n.*, the Supreme Court prohibited Idaho from taxing dividends paid by non-unitary subsidiaries. 458 U.S. 307 (1982). The Court described Idaho's extension of its taxing power as "a mere effort to reach profits earned elsewhere under the guise of legitimate taxation." *Id.* at 328 (*quoting Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n.*, 266 U.S. 271, 283 (1924)).⁵ California's interest offset pro-

⁵ See, also *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) "Where the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State, due process considerations might well preclude ap-

vision results in the same unconstitutional reach of taxation. It makes no practical or theoretical difference whether the State directly taxes the dividend income or indirectly denies an expense deduction equal to the amount of the dividend income. In either instance the State has not "given anything for which it can ask return." *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940). This Court should grant the petition for the writ of *certiorari* in order to prevent California and other States from engaging in the circuitous taxation of income that is otherwise beyond its reach.

CONCLUSION

The interest offset provision limits the availability of a deduction to corporations domiciled outside the State while allowing in-state domiciliaries the full benefit of the deduction. This discriminatory treatment violates the Commerce Clause of the United States Constitution. Further, the interest offset provision limitation on the deductibility of an interest expense deduction has the effect of subjecting to California taxation non-unitary income allocated outside the State. This taxation of extraterritorial values violates the Due Process Clause of the United States Constitution. It is imperative that this Court grant review to rectify California's unconstitutional taxation and deter other States from pursuing indirect forms of unconstitutional taxation.

portionability, because there would be no underlying unitary business." *Id.* at 442

Respectfully submitted,

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NOV 12 1999

OFFICE OF THE CLERK

No. 98-2043

In The
Supreme Court of the United States

HUNT-WESSON, INC.,

v.

Petitioner,

FRANCHISE TAX BOARD,

Respondent.

On Writ Of Certiorari To The Court Of Appeal
 Of California For The First Appellate District

JOINT APPENDIX

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**Petition For Certiorari Filed June 22, 1999
 Certiorari Granted September 28, 1999**

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RELEVANT DOCKET ENTRIES**In the Superior Court of California,
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3/7/96	Verified Complaint for Refund of Taxes filed by Hunt Wesson
6/19/96	Answer filed by Franchise Tax Board
2/5/97	Assigned to Judge Kramer for trial
2/6/97	Joint Stipulation of Facts filed by parties
2/14/97	Hunt Wesson's Post-Trial Opening Brief filed; Franchise Tax Board's Trial Brief filed
3/13/97	Franchise Tax Board's Reply Brief filed
3/14/97	Hunt Wesson's Reply Brief filed
3/24/97	Court trial held and continued to 4/11/97 at 9:00 a.m.
4/10/97	Hunt Wesson's request for Statement of Decision filed; Hunt Wesson's Supplemental Response to Court's Inquiries filed; Franchise Tax Board's request for Statement of Decision filed; Franchise Tax Board's Supplemental Trial Brief filed
4/11/97	Court trial resumed; Supplement to Joint Stipulation of Facts filed
5/2/97	Second Supplement to Joint Stipulation of Facts filed
6/6/97	Proposed Statement of Decision filed
6/20/97	Franchise Tax Board's Objections to Proposed Statement of Decision and Request for Hearing on Objections filed
6/23/97	Judgment filed

6/24/97 Notice of Entry of Judgment filed
 6/3/99 Judgment following appeal filed
 6/7/99 Notice of Entry of Judgment Following
 Appeal filed

**In the Court of Appeal of the State of California
 For the First Appellate District**

9/15/97 Notice of Appeal filed by Franchise Tax Board
 1/15/98 Franchise Tax Board's Opening Brief filed
 3/18/98 Hunt Wesson's Brief filed
 4/7/98 Franchise Tax Board's Reply Brief filed
 9/22/98 Case argued and submitted
 12/11/98 Opinion filed. Reversed and remanded to the
 trial court with directions to enter judgment
 for the Franchise Tax Board
 12/23/98 Hunt Wesson's Petition for Rehearing filed
 1/5/99 Franchise Tax Board's Request to Publish
 Opinion filed
 1/8/99 Petition for Rehearing denied
 1/11/99 Order denying publication filed
 1/21/99 Petition for Review in California Supreme
 Court received
 3/30/99 Remittitur issued
 7/1/99 Filed letter from United States Supreme Court
 indicating Petition for Writ of Certiorari filed
 10/5/99 Filed letter from United States Supreme Court
 indicating that Petition for Writ of Certiorari
 granted

In the California Supreme Court

1/20/99 Hunt Wesson's Petition for Review filed; Fran-
 chise Tax Board's Request For Publication
 filed
 2/9/99 Franchise Tax Board's Answer to Petition for
 Review filed
 3/24/99 Hunt Wesson's Petition for Review denied;
 Franchise Tax Board's Request for Publication
 denied

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 Merger with Beatrice Company, Formerly
 Known as CagSub, Inc., a Successor in
 Interest to Beatrice Companies, Inc.,
 Formerly Known as Beatrice Foods Company

SUPERIOR COURT OF THE STATE OF CALIFORNIA
 COUNTY OF SAN FRANCISCO

HUNT-WESSON, INC.,	)	No 976628
Formerly Known as)	
Beatrice/Hunt-Wesson, a	)	VERIFIED
Successor by Merger with	)	COMPLAINT FOR
Beatrice Company,	)	REFUND OF TAXES
Formerly Known as	)	Date:
CagSub, Inc., a Successor	)	Time:
in Interest to Beatrice)	
Companies, Inc., Formerly	)	(Filed Mar. 7, 1996)
Known as Beatrice Foods)	
Company,)	

Plaintiff,)
v.)
FRANCHISE TAX BOARD,)
an Agency of the State of)
California,)
Defendant.)

Plaintiff complains and alleges as follows:

1. Plaintiff, Hunt-Wesson, Inc., Formerly Known as Beatrice/Hunt-Wesson, a Successor by Merger with Beatrice Company, Formerly Known as CagSub, Inc., a Successor in Interest to Beatrice Companies, Inc., Formerly Known as Beatrice Foods is, and at all relevant times was, a corporation organized and existing under the laws of Delaware, with its principal place of business in Fullerton, California.

2. Defendant, Franchise Tax Board, is, and at all times mentioned herein was, an agency of the State of California empowered to assess and collect taxes under the California Revenue and Taxation Code, and to make refunds of overpayments of such taxes, with interest.

3. Jurisdiction and venue for this action is vested in this Court under Sections 19382 et seq. of the Revenue and Taxation Code and Section 401 of the Code of Civil Procedure.

4. This is an action for refund of franchise taxes paid by Plaintiff under the provisions of the California Revenue and Taxation Code for the fiscal years ended February 28, 1981 and February 28, 1982 ("the fiscal years in issue").

5. Plaintiff filed timely California franchise tax returns with Defendant for the fiscal years in issue.

6. During the fiscal years in issue, Plaintiff incurred interest expense in the amounts set forth in Exhibit A, attached to this Complaint. All such interest expense was claimed as a deduction on Plaintiff's California franchise tax returns for the fiscal years in issue.

7. During the fiscal years in issue, Plaintiff owned directly or indirectly certain non-unitary interest and dividend paying subsidiaries, each of which was incorporated under the laws of a state other than California or of a foreign country.

8. All of the interest expense claimed by Plaintiff as a deduction for the fiscal years in issue was paid on debt obligation incurred in the unitary business conducted by Plaintiff.

9. The disallowance of Plaintiff's interest expense by Defendant was due entirely to the receipt by Plaintiff of interest and dividends from its non-unitary subsidiaries.

10. None of the interest or dividends from the non-unitary subsidiaries was subject to taxation by the State of California.

11. On October 14, 1988, Defendant issued an assessment for the fiscal years in issue to Plaintiff indicating the following deficiencies in franchise tax:

<u>Fiscal Year Ended</u>	<u>Amount</u>
2/28/81	\$592,685.00
2/28/82	930,777.00
Total Deficiency	<u>\$1,523,462.00</u>

12. Plaintiff paid the above deficiencies, and on May 19, 1989, Plaintiff filed a timely claim for refund for the fiscal years in issue. A copy of the Claim for Refund is attached to this Complaint as Exhibit B and is referred to and made a part of this Complaint as if set out fully in this paragraph. Plaintiff, by this reference, expressly realleges without repeating herein, each and every allegation made and fact stated in the Claim for Refund and the exhibits attached thereto.

13. On June 4, 1991, Defendant issued a Notice of Action on Plaintiff's claim for refund denying Plaintiff's refund in its entirety.

14. On August 30, 1991, Plaintiff timely filed an appeal of Defendant's Notice of Action with the California State Board of Equalization ("SBE").

15. On August 23, 1995, Plaintiff and Defendant entered into a stipulation before the SBE that for the fiscal years ended February 29, 1980, February 28, 1981 and February 28, 1982, Plaintiff overpaid franchise tax in the amounts of \$3,456.00, \$4,565.00 and \$4,293.00, respectively. Plaintiff and Defendant further stipulated that the above amounts, plus interest allowed by law, be applied first to reduce any amounts Plaintiff owed under the Bank and Corporation Tax Law and the balance be refunded to Plaintiff. Further, because the SBE lacks jurisdiction to determine the constitutionality of California Revenue & Taxation Code provisions, Plaintiff and Defendant stipulated that the appeal filed by Plaintiff with the SBE on August 30, 1991 be dismissed by the SBE without prejudice.

16. Thereafter, on December 12, 1995, Defendant issued a Notice of Action on Cancellation, Credit, or Refund (attached as Exhibit C) granting Plaintiff certain refunds for the fiscal years in issue to the extent agreed in the August 23, 1995 stipulation and denying the remainder of Plaintiff's claim for refund.

17. Plaintiff has exhausted all necessary administrative remedies and has timely filed this suit for refund pursuant to Revenue and Taxation Code Sections 19382 et seq.

18. All of the non-unitary interest and dividends were immune from taxation by the State of California by reason of the United States Constitution. *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 102 S. Ct. 3103 (1982); *F.W. Woolworth Co. v. Tax. & Rev. Dept.*, 458 U.S. 354, 102 S. Ct. 3128 (1982).

19. None of the disallowed interest expense was economically related to the non-unitary interest or dividends.

20. All of the non-unitary interest and dividends received by Plaintiff constituted non-unitary income.

21. The arbitrary limitation of Plaintiff's interest expense deduction by the amount of non-unitary interest and dividends constitutionally immune from taxation by the State of California results in a dollar-for-dollar indirect taxation of such constitutionally immune income.

22. Defendant erred under the California Revenue & Taxation Code in failing to grant the claim for refund in part, plus interest thereon, because the application of the "interest offset" provision under California Revenue &

Taxation Code Section 24344 violates the California Constitution and the United States Constitution, including, but not limited to: (1) the Due Process and Equal Protection Clauses of the Fourteenth Amendment of the United States Constitution, (2) the Commerce Clause (Article I, Section 8) of the United States Constitution, and (3) the Due Process and Equal Protection Clauses (Article I, Section 7) of the California Constitution.

WHEREFORE, Plaintiff prays for judgment as follows:

1. For a refund of taxes paid in the amount of \$1,523,462, less the amount of tax refunded to Plaintiff pursuant to the Notice of Action on Cancellation, Credit, or Refund dated December 12, 1995;
2. For interest on these amounts as provided by law;
3. For attorney's fees and costs of suit as provided by law; and
4. For such other and further relief as this Court may deem appropriate.

Dated: March 6, 1996

Charles J. Moll III
Edwin P. Antolin
Morrison & Foerster LLP
Fred O. Marcus
Horwood, Marcus & Braun

By: /s/ Charles J. Moll III
Charles J. Moll III

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 Beatrice/Hunt-Wesson, a
 Successor by Merger with
 Beatrice Company, Formerly
 Known as CagSub, Inc., a
 Successor in Interest to
 Beatrice Companies, Inc.,
 Formerly Known as Beatrice
 Foods Company

VERIFICATION

I am the Vice President for the Plaintiff, HUNT-WESSON, INC., Formerly Known as Beatrice/Hunt-Wesson, a Successor by Merger with Beatrice Company, Formerly Known as CagSub, Inc., a Successor in Interest to Beatrice Companies, Inc., Formerly Known as Beatrice Foods Company, and I am authorized to make this Verification on behalf of said entity.

I have read the foregoing Complaint and know the contents thereof, I am informed and believe that the information contained in said document is true, and on the ground I allege that the information stated therein is true.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Executed this 5th day of March, 1996, at Chicago, IL.

/s/ Raymond V. Hartman
 (Signature)

[Exhibits And Proof Of Service Omitted In Printing]

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**SUPERIOR COURT OF THE STATE OF CALIFORNIA
COUNTY OF SAN FRANCISCO**

HUNT-WESSON, INC.,)	No. 976628
Formerly Known as Beatrice/)	
Hunt-Wesson, a Successor by)	
Merger with Beatrice Company,	)	ANSWER TO
Formerly Known as CagSub,	)	VERIFIED
Inc., a Successor in Interest to	)	COMPLAINT
Beatrice Companies, Inc.,	)	FOR REFUND
Formerly Known as Beatrice	)	<u>OF TAXES</u>
Foods Company,)	
Plaintiff,)	
v.	)	(Filed
FRANCHISE TAX BOARD, an	)	Jun. 19, 1996)
Agency of the State of)	
California,)	
Defendants.)	
)	

Defendant, Franchise Tax Board ("Board"), answers the verified complaint of plaintiff, Hunt-Wesson, Inc., in this action as follows:

1. Answering paragraph 1, the Board admits that plaintiff, Hunt-Wesson, Inc., is formerly known as Beatrice/Hunt-Wesson, which is a successor by merger with Beatrice Company, which is formerly known as CagSub, Inc. The Board further admits that plaintiff is a corporation organized and existing under the laws of Delaware. However, the Board is without sufficient information or belief to admit or deny that CagSub, Inc., is a successor in interest to Beatrice Companies, Inc., or that Beatrice Companies, Inc., is formerly known as Beatrice Foods, or that plaintiff's principal place of business is Fullerton, California. Based on this lack of sufficient information or belief, the Board denies these allegations.

2. Admits the allegations in paragraph 2.

3. Denies the allegations in paragraph 3.

4. Admits the allegations in paragraph 4.

5. Admits the allegations in paragraph 5.

6. Answering paragraph 6, the Board admits that plaintiff claimed interest expense in the amounts set forth in Exhibit A, attached to plaintiff's complaint, as a deduction on plaintiff's California franchise tax returns for the fiscal years in issue (fiscal years ended February 28, 1981 and February 28, 1982). However, the Board is without sufficient information or belief to admit or deny that plaintiff incurred the above-claimed interest expense during the fiscal years in issue. Based on this lack of information or belief, the Board denies this allegation.

7. Answering paragraph 7, the Board is without sufficient information or belief to admit or deny the

allegations in this paragraph. Based on this lack of information or belief, the Board denies the allegations.

8. Denies the allegations in paragraph 8.

9. Denies the allegations in paragraph 9.

10. Denies the allegations in paragraph 10.

11. Admits the allegations in paragraph 11.

12. Answering paragraph 12, the Board admits that plaintiff paid the deficiencies alleged in paragraph 11 of the complaint. The Board further admits that plaintiff filed a timely claim for refund, set forth as Exhibit B of plaintiff's complaint, for the fiscal years in issue. However, the Board denies the allegations stated in plaintiff's claim for refund and the exhibits attached thereto.

13. Admits the allegations in paragraph 13.

14. Admits the allegations in paragraph 14.

15. Admits the allegations in paragraph 15.

16. Admits the allegations in paragraph 16.

17. Denies the allegations in paragraph 17.

18. Denies the allegations in paragraph 18.

19. Denies the allegations in paragraph 19.

20. Denies the allegations in paragraph 20.

21. Denies the allegations in paragraph 21.

22. Denies the allegations in paragraph 22.

23. The Board denies generally each and every allegation of the complaint not hereinbefore specifically admitted, qualified, or denied.

AFFIRMATIVE DEFENSES

24. The Board affirmatively alleges that plaintiff has failed to state facts sufficient to constitute a cause of action.

25. The Board affirmatively alleges this Court is without jurisdiction to consider plaintiff's request for attorney's fees and costs of suit on the ground that plaintiff has failed to exhaust its administrative remedies.

WHEREFORE, the Board requests judgment as follows:

1. That the relief sought in the complaint be denied.
2. That the actions of the Board, as set forth in this Answer, be in all respects approved.
3. That this Court order all further reasonable relief.

Dated: June 19, 1996.

DANIEL E. LUNGREN, Attorney
General of the State of California

/s/ David Lew
DAVID LEW
Deputy Attorney General
Attorneys for Defendant
Franchise Tax Board

[Proof Of Service Omitted In Printing]

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 Merger with Beatrice Company, Formerly
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 Interest to Beatrice Companies, Inc.,
 Formerly Known as Beatrice Foods Company

SUPERIOR COURT OF THE STATE OF CALIFORNIA
 COUNTY OF SAN FRANCISCO

HUNT-WESSION, INC.,	)	No 976628 (PLAN I)
Formerly Known as)	
Beatrice/Hunt-Wesson, a	)	JOINT
Successor by Merger with	)	STIPULATION OF
Beatrice Company,	)	FACTS
Formerly Known as	)	Trial: February 5, 1997
CagSub, Inc., a Successor	)	Place: Department 17
in Interest to Beatrice	)	(Filed Feb. 6 1997)
Companies, Inc., Formerly)	
Known as Beatrice Foods)	
Company,)	

Plaintiff,)
)
v.)
)
FRANCHISE TAX BOARD,)
an Agency of the State of)
California,)
)
Defendant.)

IT IS HEREBY STIPULATED by and between Plaintiff Hunt-Wesson, Inc., and Defendant Franchise Tax Board ("Defendant," "the "FTB," or "the Board"), through their attorneys of record, that the following facts are agreed and undisputed. Unless specifically stated herein, these facts pertain to the fiscal years ended February 29, 1980, February 28, 1981, and February 28, 1982 ("the fiscal years in issue," "the income years in issue," or "FYE 2/29/80, FYE 2/28/81 and FYE 2/28/82"). This stipulation shall not be construed as a concession by either party of the relevance or materiality of any of the facts stipulated. The parties reserve the right to object to the admission of any document, or group of documents, or any stipulated fact, on any grounds other than those specifically waived by this stipulation.

All of the documents attached to this stipulation and marked as Joint Exhibits 1 through 6 have been reviewed by counsel for the parties, and it is admitted that they are authentic and are business records of the parties and are deemed admitted into evidence in this trial. Pursuant to California Evidence Code section 1511, photocopies of these documents will also be admitted into evidence for purposes of trial in place of the originals.

Nothing contained herein shall be construed as a waiver by any party of its right to review on appeal any question of law or fact arising in this action in the same manner and to the same extent as if the facts set forth herein had been proved in open court.

FACTS

The following facts are agreed upon and undisputed:

1. Plaintiff Hunt-Wesson, Inc., a corporation qualified to do business in California, is a successor in interest to Beatrice Companies, Inc. and Beatrice Foods Company (collectively "Beatrice"). At all relevant times Beatrice was a corporation organized and existing under the laws of Delaware, and domiciled in Illinois.

2. During the fiscal years in issue, Beatrice was a diversified company, primarily engaged in a business, both within and without California, providing food and food-related products and services for worldwide markets. Beatrice also produced other consumer, industrial and chemical products.

3. Defendant, Franchise Tax Board, is, and at all times mentioned herein was, an agency of the State of California empowered to assess and collect taxes under the California Revenue and Taxation Code, and to make refunds of overpayments of such taxes, with interest.

4. This is an action for refund of franchise taxes and interest paid by Beatrice to Defendant under the provisions of the California Revenue and Taxation Code with respect to the fiscal years ended February 28, 1981 and February 28, 1982.

5. Jurisdiction and venue for this action are vested in this Court under Sections 19382 et seq. of the Revenue and Taxation Code and Section 401 of the Code of Civil Procedure.

6. Beatrice filed timely California franchise tax returns with Defendant for the fiscal years in issue.

7. During the fiscal years in issue, Beatrice owned directly and indirectly certain dividend paying subsidiaries, none of which were incorporated in California and most of which were incorporated under the laws of a foreign country. None of these subsidiaries were engaged in a unitary business with Beatrice. These nonunitary subsidiaries paid the following dividends to Beatrice during the fiscal years in issue: \$26,718,620 for FYE 2/29/80, \$29,482,367 for FYE 2/28/81, and \$19,022,617 for FYE 2/28/82 ("nonunitary dividends" or "nonbusiness dividends").

8. All of these nonunitary dividends received by Beatrice constituted nonunitary, nonbusiness income not subject to apportionment, or taxation, by the State of California. However, such nonunitary dividends were taxable by the State of Illinois, Beatrice's state of domicile, during the fiscal years in issue.

9. For the fiscal years at issue, Beatrice did not make direct operating loans to its foreign subsidiaries. Each foreign subsidiary was directly responsible for its own borrowings.

10. During the fiscal years in issue, Beatrice incurred interest expense in the following amounts: \$80,490,469 for FYE 2/29/80, \$55,101,503 for FYE

2/28/81, and \$137,413,162 for FYE 2/28/82. Attached hereto as Exhibit 1 is a schedule that lists the debt and related interest expense giving rise to the interest expense deduction at issue for each year in issue. All such interest expense was reported as business interest expense and claimed as a deduction on Beatrice's California franchise tax returns for the fiscal years in issue.

11. During the fiscal years in issue, the so-called "interest offset" provision of Section 24344 of the Revenue & Taxation Code was calculated on Schedule R-5 of Defendant's Form 100 ("Corporation Franchise or Income Tax Return"). Attached hereto as Exhibit 2 is Schedule R (entitled "Schedule of Apportionment and Allocation of Income") for FYE 2/28/82. In all relevant parts, Schedule R for FYE 2/29/80 and FYE 2/28/81 was identical to Exhibit 2. Before the "interest offset" computation was made starting with line 3 of Schedule R-5, nonbusiness interest expense (line 2 of Schedule R-5) was deducted from total interest expense (line 1 of Schedule R-5). Thus, the remaining interest expense reportable on line 3 of Schedule R-5 was business interest expense subject to the "interest offset" computation.

12. After conducting an audit of the fiscal years in issue and pursuant to Section 24344, Defendant disallowed Beatrice's interest expense deduction on a dollar-for-dollar basis to the extent of the dividends that Beatrice received from its nonunitary subsidiaries. A copy of Defendant's report from that audit (including schedules) is attached hereto as Exhibit 3.

13. In computing Beatrice's "interest offset," Defendant determined that the aggregate interest expenses on

Exhibit I were reportable as interest expense on line 3 of Schedule R-5, and thus were subject to the "interest offset" computation.

14. The disallowance of Beatrice's interest expense was due entirely to the receipt by Beatrice of dividends from its nonunitary subsidiaries as set forth in Schedule I(k) to Defendant's audit report. A copy of Schedule I(k) is attached hereto as Exhibit 4.

15. Defendant's position denying Beatrice an interest deduction pursuant to Section 24344 is based upon the analysis and holding reached by the California Supreme Court in *Pacific Telephone and Telegraph v. Franchise Tax Board*, 7 Cal. 2d 3d 544 (1972).

16. On October 14, 1988, Defendant issued a Computation of Proposed Overpayment and two Notices of Additional Tax To Be Assessed for FYE 2/29/80, FYE 2/28/81, and FYE 2/28/82, which set forth the following proposed deficiencies/(overpayment) of California franchise tax:

<u>Fiscal Year Ended</u>	<u>Amount</u>
2/29/80	(\$327,458.29)
2/28/81	592,685.00
2/28/82	930,777.00
Net Deficiency	<u>\$1,196,003.71</u>

17. On December 1, 1988, Beatrice executed a Consent to Transfer in which Beatrice agreed to permit Defendant to credit against the proposed deficiency for FYE 2/28/81 the overpayment with interest thereon for FYE 2/29/80 in the aggregate amount of \$804,127.91. Because

of Defendant's disallowance of Beatrice's interest expense for FYE 2/29/80, the credit against the proposed deficiency for FYE 2/28/81 was less than it would have been had the interest expense deductions been allowed. Consequently, the tax and interest paid and at issue with respect to FYE 2/28/81 is attributable both to the disallowance of Beatrice's interest expense for FYE 2/28/81, and to the disallowance of Beatrice's interest expense for FYE 2/29/80.

18. Beatrice paid the remaining proposed deficiency and interest for the fiscal years in issue in two installments: on or about March 15, 1989, Beatrice paid \$2,170,458.46, and on or about July 14, 1989 Beatrice paid \$387,094.40 (after Defendant allowed a credit of \$28,883.09).

19. The total additional tax and interest paid by Beatrice for FYE 2/28/81 was \$1,379,741.79 (consisting of \$592,685 in tax and \$787,056.79 in interest), and for FYE 2/28/82 was \$2,010,822.07 (consisting of \$930,777 in tax and \$1,080,045.07 in interest).

20. The disputed tax and interest attributable to Defendant's disallowance of Beatrice's interest expense and paid by Beatrice was \$139,066 (consisting of tax only) for FYE 2/29/80, \$396,883.10 (consisting of \$170,486 tax and \$226,397.10 interest) for FYE 2/28/81, and \$236,862.89 (consisting of \$109,640 tax and \$127,222.89 interest) for FYE 2/28/82.

21. On May 19, 1989, Beatrice filed with Defendant a timely claim for refund.

22. On June 4, 1991, Defendant denied Beatrice's refund claim in its entirety.

23. On August 30, 1991, Beatrice timely filed an appeal of Defendant's Notice of Action with the California State Board of Equalization ("SBE").

24. On August 23, 1995, Beatrice and Defendant entered into a stipulation before the SBE that for the fiscal years ended February 29, 1980, February 28, 1981 and February 28, 1982, Beatrice overpaid franchise tax in the amounts of \$3,456.00, \$4,565.00 and \$4,293.00, respectively. Beatrice and Defendant further stipulated that the above amounts, plus interest allowed by law, be applied first to reduce any amounts Beatrice owed under the Bank and Corporation Tax Law and the balance be refunded to Beatrice. Finally, because the SBE lacks jurisdiction to determine the constitutionality of California Revenue & Taxation Code provisions, Beatrice and Defendant stipulated that the appeal filed by Beatrice with the SBE on August 30, 1991 be dismissed by the SBE without prejudice. A copy of that stipulation is attached hereto as Exhibit 5.

25. Thereafter, on December 12, 1995, Defendant issued a Notice of Action on Cancellation, Credit, or Refund, attached hereto as Exhibit 6, granting Beatrice certain refunds for the fiscal years in issue to the extent agreed in the August 23, 1995 stipulation and denying the remainder of Beatrice's claim for refund.

26. Beatrice and its successor in interest, Plaintiff Hunt-Wesson, Inc., have exhausted all necessary administrative remedies and have timely filed this suit for refund

pursuant to Revenue and Taxation Code Sections 19382 et seq.

CHARLES J. MOLL, III
EDWIN P. ANTOLIN
Morrison & Foerster LLP

FRED O. MARCUS
HORWOOD, MARCUS & BRAUN
Chartered

Dated: February 6, 1997

By: /s/ Edwin P. Antolin
Edwin P. Antolin

Attorneys for Plaintiff
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successor by merger with Beatrice
Company, formerly known as
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Dated: February 6, 1997

By: /s/ David Lew
David Lew

Attorney for Defendant
Franchise Tax Board

[Exhibits Omitted In Printing]

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Interest to Beatrice Companies, Inc.,
Formerly Known as Beatrice Foods Company

SUPERIOR COURT OF THE STATE OF CALIFORNIA
COUNTY OF SAN FRANCISCO

HUNT-WESSON, INC., Formerly	) No. 976628 (PLAN I)
Known as Beatrice/Hunt-Wesson,)
a Successor by Merger with	) SUPPLEMENT TO
Beatrice Company, Formerly	) JOINT
Known as CagSub, Inc., a	) STIPULATION
successor in Interest to Beatrice	) OF FACTS
Companies, Inc., Formerly)
Known as Beatrice Foods	) Trial Date: March 24,
Company,	) 1997
)
Plaintiff,	) Continued Trial
	) Date: April 11, 1997
v.	

FRANCHISE TAX BOARD, an) Time: 9:00 am
 Agency of the State of California,) Place: Department 17
 Defendant.) (Filed Apr. 11, 1997)
 _____)

Plaintiff Hunt-Wesson, Inc. and Defendant Franchise Tax Board hereby submit this Supplement to Joint Stipulation of Facts.

IT IS HEREBY STIPULATED by and between Plaintiff Hunt-Wesson, Inc., and Defendant Franchise Tax Board ("Defendant," the "FTB," or "the Board"), through their attorneys of record, that the following facts are agreed and undisputed. Unless specifically stated herein, these facts pertain to the fiscal years ended February 29, 1980, February 28, 1981, and February 28, 1982 ("the fiscal years in issue," "the income years in issue," or "FYE 2/29/80, FYE 2/28/81, and FYE 2/28/82"). This stipulation shall not be construed as a concession by either party of the relevance or materiality of any of the facts stipulated. The parties reserve the right to object to the admission of any document, or group of documents, or any stipulated fact, on any grounds other than those specifically waived by this stipulation.

Nothing contained herein shall be construed as a waiver by any party of its right to review on appeal any question of law or fact arising in this action in the same manner and to the same extent as if the facts set forth herein had been proved in open court.

FACTS

The following facts are agreed upon and undisputed:

1. Rev. & Tax. Code section 19340(b) states that interest shall be allowed and paid on any overpayment in respect of any tax, at the adjusted annual rate established pursuant to Section 19521 in the case of a refund from the date of overpayment to a date preceding the date of the refund warrant by not more than 30 days, the date to be determined by the FTB. Rev. & Tax. Code section 19521 provides, in relevant part, that the adjusted annual rate shall be determined in accordance with Internal Revenue Code section 6621, except as modified by section 19521. As set forth at paragraph 20 of the Joint Stipulation of Facts, the disputed tax and interest attributable to the disallowance of Beatrice's interest expense deduction and paid by Beatrice totals \$772,811.99.

2. Illinois, Beatrice's state of domicile, did not have during the income years in issue (and does not have) a comparable provision to Rev. & Tax. Code section 24344(b), and did not provide (and does not provide) for an adjustment to income or expenses for the disallowance of business interest expense under Rev. & Tax. Code section 24344(b).

CHARLES J. MOLL III
 EDWIN P. ANTOLIN
 Morrison & Foerster LLP
 FRED O. MARCUS
 Horwood, Marcus & Braun
 Chartered

Dated: April 10, 1997 By: /s/ Edwin P. Antolin
Edwin P. Antolin
 Attorneys for Plaintiff

DANIEL E. LUNGREN, Attorney
 General of the State of California

DAVID LEW, Deputy Attorney
 General

Dated: April 10, 1997 By: /s/ David Lew
David Lew
 Attorney for Defendant

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 Known as CagSub, Inc., a Successor in
 Interest to Beatrice Companies, Inc.,
 Formerly Known as Beatrice Foods Company

SUPERIOR COURT OF THE STATE OF CALIFORNIA
 COUNTY OF SAN FRANCISCO

HUNT-WESSON, INC., Formerly	) No. 976628 (PLAN I)
Known as Beatrice/Hunt-Wesson,)
a Successor by Merger with	) SECOND
Beatrice Company, Formerly	) SUPPLEMENT TO
Known as CagSub, Inc., a	) JOINT
Successor in Interest to Beatrice	) STIPULATION OF
Companies, Inc., Formerly	) FACTS
Known as Beatrice Foods)
Company,	) Trial Date: March 24,
	) 1997
Plaintiff,)
v.	) Continued Trial

FRANCHISE TAX BOARD, an) Date: April 11, 1997
 Agency of the State of California,) Time: 9:00 am
 Defendant.) Place: Department 17
) (Filed May 2, 1997)
)

Plaintiff Hunt-Wesson, Inc. and Defendant Franchise Tax Board hereby submit this Second Supplement to Joint Stipulation of Facts.

IT IS HEREBY STIPULATED by and between Plaintiff Hunt-Wesson, Inc., and Defendant Franchise Tax Board ("Defendant," the "FTB," or "the Board"), through their attorneys of record, that the following facts are agreed and undisputed. Unless specifically stated herein, these facts pertain to the fiscal years ended February 29, 1980, February 28, 1981, and February 28, 1982 ("the fiscal years in issue," "the income years in issue," or "FYE 2/29/80, FYE 2/28/81, and FYE 2/28/82"). This stipulation shall not be construed as a concession by either party of the relevance or materiality of any of the facts stipulated. The parties reserve the right to object to the admission of any document, or group of documents, or any stipulated fact, on any grounds other than those specifically waived by this stipulation.

Nothing contained herein shall be construed as a waiver by any party of its right to review on appeal any question of law or fact arising in this action in the same manner and to the same extent as if the facts set forth herein had been proved in open court.

FACTS

The following facts are agreed upon and undisputed:

1. Paragraph 20 of the Joint Stipulation of Facts, dated February 6, 1997, and Paragraph 1 of the Supplement to Joint Stipulation of Facts should be disregarded in their entirety.

2. As set forth in detail in Exhibit A, attached hereto, the disputed tax and interest paid attributable to Defendant's disallowance of Beatrice's interest expense plus accrued interest from the date of payment is \$762,073.12 for FYE 2/29/80 (consisting of \$139,066.00 tax paid and \$623,007.12 interest accrued from May 15, 1980 to May 2, 1997); \$855,926.32 for FYE 2/28/81 (consisting of \$170,486 tax paid, \$232,752.71 interest paid, and \$452,687.61 interest accrued from March 15, 1989 to May 2, 1997); and \$640,021.00 for FYE 2/28/82 (consisting of \$109,640.00 tax paid, \$135,803.62 interest paid, and \$394,577.38 interest accrued from July 15, 1989 to May 2, 1997). The total amount of tax paid, interest paid, and interest accrued from the dates of payment to May 2, 1997 equals \$2,258,020.44.

3. A refund of the tax paid, interest paid and accrued interest that is paid after May 2, 1997 shall equal \$2,258,020.44 plus interest from May 2, 1997 as calculated under Rev. & Tax. Code section 19391.

CHARLES J. MOLL III
 EDWIN P. ANTOLIN
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FRED O. MARCUS
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Dated: May 2, 1997 By: /s/ Edwin P. Antolin
Edwin P. Antolin
Attorneys for Plaintiff

DANIEL E. LUNGREN, Attorney
General of the State of California

DAVID LEW, Deputy Attorney
General

Dated: May 2, 1997 By: /s/ David Lew
David Lew
Attorney for Defendant

[Exhibits Omitted In Printing]

SUPERIOR COURT OF CALIFORNIA
CITY AND COUNTY OF SAN FRANCISCO
DEPARTMENT 17

HUNT-WESSON, INC., Formerly	)	No. 976628
Known as Beatrice/Hunt Wesson,)	
a Successor by Merger with	)	PROPOSED
Beatrice Company, Formerly	)	STATEMENT
Known as CagSub, Inc., a	)	OF DECISION
Successor in Interest to Beatrice	)	[C.C.P. § 632]
Companies, Inc., Formerly Known	)	(Filed JUN-6 1997)
as Beatrice Foods Company,)	
Plaintiff,)	
v.)	
FRANCHISE TAX BOARD, an)	
Agency of the State of California,)	
Defendant.)	

Upon the oral request of both parties in accordance with Code of Civil Procedure § 632, the Court makes the following Proposed Statement of Decision:

SUMMARY

This case is brought by plaintiff Hunt-Wesson, Inc. to obtain a refund of \$2,258,020.44 in taxes and interest paid to the defendant Franchise Tax Board in its fiscal years 1980, 1981 and 1982. This amount is an alleged overpayment plus (accrued interest) resulting from the application of Revenue and Taxation Code ("Rev. & T.C.")

§ 24344(b) to plaintiff's claimed business interest expense deductions for the subject three tax years. Under Rev. & T.C. § 24344(b), the defendant disallowed a portion of plaintiff's business interest expense on a dollar-for-dollar basis with plaintiff's non-unitary subsidiary dividends for the subject years. Plaintiff concedes that Rev. & T.C. § 24344 was applied in accordance with its terms, but asserts that the statutory provisions that allow for business interest expense deductions to be offset by non-unitary dividends violate the Due Process, Commerce and Equal Protection Clauses of the United States Constitution.

FACTS

This matter was submitted upon a Joint Stipulation of Facts filed herein on February 6, 1997 ("JS"), a Supplement to Joint Statement of Facts filed herein on April 11, 1997, and a Second Supplement to Joint Statement of Facts filed herein on May 2, 1997 ("JS 2nd") which establish that:

A. Plaintiff¹ is a Delaware corporation, domiciled in Illinois (JS ¶ 1).

¹ Plaintiff Hunt-Wesson, Inc. is successor in interest to other entities, the identities of which changed over the years relevant to this action. The details of this evolution, which are specified in the Joint Statement of Facts, are not relevant to this Statement of Decision as Plaintiff is the successor in interest to the actual taxpayer of the disputed payments. For simplicity, the term "Plaintiff" shall be used throughout this Statement to refer to the taxpayer and its successor in interest.

B. During its fiscal years ending February 28 of 1980, 1981 and 1982 ("the relevant fiscal years"), plaintiff was a diversified company engaged in the food products business both within and outside of California (JS ¶ 2).

C. During the relevant fiscal years, plaintiff owned dividend paying subsidiaries, none of which were either incorporated in California or engaged in a unitary business with Plaintiff (JS ¶ 7).

D. The non-unitary subsidiaries paid plaintiff the following dividends: \$26,718,620 for fiscal year 1980; \$29,482,367 for fiscal year 1981; and \$19,022,617 for fiscal year 1982 ("the nonbusiness dividends") (JS ¶ 7).

E. All of the nonbusiness dividends were not taxable by the State of California but were taxable by the State of Illinois (JS ¶ 8).

F. During the relevant fiscal years, plaintiff incurred the following business interest expense, which it claimed as a deduction on its California Franchise Tax Returns for the respective years: \$80,490,469 for fiscal year 1980; \$55,101,503 for fiscal year 1981; and \$137,413,162 for fiscal year 1982 (JS ¶ 10).

G. Exhibit 1 to the Joint Stipulation of Facts is a list of the debt and related expenses giving rise to the foregoing claimed business interest expense deductions. No portion of these amounts was related to borrowings of the non-unitary subsidiaries which provided the above-specified dividends to plaintiff (JS ¶ 9).

H. Pursuant to Rev. & T.C. § 24344(b), defendant disallowed plaintiff's business interest expense

deductions on a dollar-for-dollar basis to the extent of the dividends that plaintiff received from its non-unitary subsidiaries (JS ¶12).

I. As a result of the disallowance of business interest expense, plaintiff paid further taxes and interest thereon, the amounts of which plus accrued interest from the respective dates of payment for the relevant fiscal years are as follows: \$762,073.12 (consisting of \$139,066.00 tax plus \$623,007.12 interest accrued from May 15, 1980 through May 1, 1997) for fiscal year 1980; \$855,926.32 (consisting of \$170,486 tax plus \$232,752.71 interest paid plus \$452,687.61 interest accrued from March 15, 1989 through May 1, 1997) for fiscal year 1981; and \$640,021.00 (consisting of \$109,640.00 tax plus \$135,803.62 interest paid plus \$394,577.38 interest accrued from July 15, 1989 through May 1, 1997) for fiscal year 1982 (JS 2nd, ¶20).

J. Plaintiff has satisfied all procedural requirements to bring this action for refund of the disputed payments (JS ¶¶21.23, 26).

ISSUES PRESENTED

Plaintiff's claim for refund is based on the argument that the provisions of Rev. & T. C. § 24344(b) which allow this state to offset business interest deductions claimed by foreign corporations on a dollar-for-dollar basis with such corporations' non-unitary dividends violate the Due Process, Commerce and/or Equal Protection Clauses of

the United States Constitution. As a threshold issue, however, it must be determined whether Pacific Telephone & Telegraph v. Franchise Tax Board, 7 Cal. 3d 544 (1972) precludes any Constitutional analysis of the subject provisions.

ANALYSIS

A. The Revenue & Taxation Code

California's Bank and Corporation Tax Law (Rev. & T.C. §§ 23001 et seq) is, in relevant part, a tax on corporations doing business in this state for the privilege of exercising corporate franchises in California. Rev. & T.C. § 23151. When a corporation does business both within and outside of California, the statutory scheme apportions "business income"² by the application of a formula which, simply put, determines the portion of such income attributable to three business factors (sales, property and payroll) which are connected with this state and taxes accordingly. Rev. & T.C. 25128. In contrast, corporate dividends are "non-business income" and are not allocated to this state unless the taxpayer is domiciled here. Rev. & T.C. § 25126. Income allocated to California under these rules is taxable by California. Rev. & T.C. § 25101.

In calculating a taxpayer's net taxable income, business interest expense is generally deducted from business income. Rev. & T.C. § 24344(a). Taxpayers must, however, offset their interest expense deductions on a dollar-for-

² "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business. Rev. & T.C. § 25120.

dollar basis with any non-business income not allocable to California. Rev. & T.C. §24344(b). This means that corporations not domiciled in California must reduce their interest deduction (in California) by the amount of their nontaxable (by California) dividend income. It is this effect that plaintiff asserts is unconstitutional.

B. Pacific Telephone & Telegraph v. Franchise Tax Board

Defendant asserts that Pacific Telephone & Telegraph v. Franchise Tax Board, *supra*, 7 Cal. 3d 544, is determinative of the issues in this case.

In Pacific Telephone, the issue presented was whether the phrase "interest and dividend income...not subject to allocation by formula" as an offset against interest deductions under Rev. & T.C. § 24344(b) should be interpreted to include all intercompany dividends.

The Court held that as a matter of statutory interpretation, logic and public policy, such intercompany dividends should be included in the subject phrase. The Court rejected Pacific Telephone's assertion that only *taxable* intercompany dividends be included in the offset because such phrase was not used in the statute and because other non-taxable dividends were expressly excluded from the computation under the statute, which express exclusion would be unnecessary if all nontaxable dividends were to be excluded. 7 Cal. 3d. at 554. The Court also found that logically, dividends are income whether or not taxed. *Id.* Finally, the Court found that its interpretation that nontaxable dividends should be offset against interest deductions was appropriate to close a potential loophole whereby a foreign corporation could

increase its borrowings to create a deduction and use the loan proceeds to buy stocks which would create nontaxable dividend income. 7 Cal. 3d at 554.

The Court did not expressly discuss any constitutional parameters for its statutory interpretation.³ The absence of any constitutionally-based holding in Pacific Telephone renders that opinion not controlling on the constitutional challenges raised here. Amwest Surety Ins. Co. v. Wilson, 11 Cal 4th 1243, 1268 (1995) ["an opinion is not authority for a proposition not therein considered," quoting Gunns v. Savage, 61 Cal. 2d 520, 524 (1964)].

C. Constitutional Analysis.

Plaintiff asserts that the offset provisions of Rev. & T.C. § 24344 (b) violate three separate clauses of the United States Constitution: the Due Process Clause, the Commerce Clause, and the Equal Protection Clause. As a general matter, every statute is clothed with a presumption of Constitutionality. County of Sonoma v. State Energy Resources Conservation Etc. Comm., 40 Cal. 3d 361, 368-70 (1985). The power of the legislature in the area of taxation is paramount, and any constitutional restriction on that power must be strictly construed against the limitation and with reference to the underlying purpose

³ It should be noted that the Court stated that the problem confronting it was largely, if not entirely, eliminated by the 1967 enactment of Rev. & T.C. §25106, which expressly dealt with the applicability of intercompany dividends under Rev. & T.C. §24344. This statutory clarification may have reduced the scope of the issues presented to the Court and might therefore explain the absence of any constitutional analysis.

of the legislation. Franchise Tax Board v. Superior Court, 212 Cal.App. 3d 1343, 1347 (1989). With these principles in mind, each of the plaintiff's challenges will be discussed separately.

1. The Due Process Clause

The Due Process Clause of the Fourteenth Amendment to the United States Constitution provides that no state shall deprive its citizens of property without due process of law. In the area of state taxation, due process protections are founded on the principle that the power to tax is exercised upon the assumption that the government is providing an equivalent value to the taxpayer in the form of protections, services or facilities. Union Refrigerator Transit Company v. Kentucky 199 U.S. 194, 202 (1905). If the taxing state government is in no position to render these protections, services or facilities to the taxpayer because the object of taxation is wholly in another state, then an attempt to tax anyway is a taking without due process of law. Id. It necessarily follows that where the objects of taxation are located in two or more states, then the due process clause requires an apportionment of tax burden so as to avoid multiple taxation without regard to the protections, services and facilities being provided by the taxing states. Standard Oil Co. v. Peck, Tax Commissioner, et al, 342 U.S. 382, 384-85 (1952). Indeed, it is this precept that forms the constitutionally permissible basis for the allocation by formula approach used in unitary tax systems such as California's. Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992) ["there must be some definite link, some minimum

connection, between a state and the person, property or transaction it seeks to tax."]

In this case, the specific due process analysis starts with two basic precepts which both parties agree upon. First is that a state may not tax plaintiff's nonbusiness dividends because plaintiff is a foreign domiciliary corporation and such income is only taxable in its state of domicile. JS ¶¶ 1 & 12, see ASARCO, Inc. v. Idaho State Tax Comm'n., 458 U.S. 307, 315-16 (1982). Second is that a state cannot tax indirectly that which it may not tax directly. (Plaintiff's Proposed Statement of Decision [C.C.P. Section 632], submitted May 2, 1997, p. 6, lines 2-13; Defendant Franchise Tax Board's Proposed Statement of Decision [Cal. Rules of Court, rule 232(c)], submitted May 2, 1997, p. 13, lines 3-8).

It is in the applicability of these two precepts to this case that the parties disagree. Plaintiff asserts that the disallowance of a deduction in the amount of the nontaxable dividends effectively increases the taxable income in California by the amount of the nontaxable dividends and thus is indirectly a tax thereon. Plaintiff contends that this is impermissible given that these dividends are not taxable in California.. Defendant argues that case authorities demonstrate that the disallowance of a deduction to the extent of certain nontaxable income is proper, especially where to do so furthers a legitimate governmental purpose. Defendant's assertion will be discussed first.

Three of the five cases cited by defendant are federal cases dealing with United States tax statutes. None of these cases analyze the questioned statutes in terms of

the due process clause. In Denman v. Slayton 282 U.S. 414 (1931), the Court upheld federal tax statutes which excluded both income on tax exempt state obligations and interest on borrowings used to purchase them. In so doing, the Court rejected the taxpayer's constitutional argument that the subject statutes unconstitutionally discriminated against him. Nowhere in the opinion, however, is the precise constitutional provision supposedly prohibiting such discrimination discussed. In Helvering v. Independent Life Ins. Co., 292 U.S. 371 (1934) the Court held that a federal tax statute limiting the deduction of depreciation and other expenses did not violate Art. I, § 9, cl. 4 of the U.S. Constitution, which requires that no direct tax be laid except in proportion to the census. The Court expressly stated that it was not considering any question regarding the Fifth Amendment, which is the Federal Due Process Clause. 292 U.S. at 373. Finally, in United States v. Atlas Life Insurance Co., 381 U.S. 233 (1965) the Court upheld the portion of the Federal Life Insurance Tax Act of 1959 which required an insurance company to allocate a portion of its tax exempt interest income to its tax deductible reserve funds, thereby reducing the amount of otherwise taxable income that could be shifted to the deductible reserve funds. In so doing, it rejected the taxpayer's argument that such requirement was unconstitutional, although their exact constitutional parameters supposedly being infringed were not specified in the opinion.⁴

⁴ The Due Process Clause applicable to the Federal Government is contained in the Fifth Amendment rather than the Fourteenth Amendment. Each due process clause applies separately to its respective governmental level. Warren v.

The remaining two cases cited by the defendant do deal with state tax provisions. The first is First Nat. Bank v. Barstow Cty. Tax Assrs. 470 U.S. 583 (1985), in which the Court upheld a Georgia tax statute which limited the exclusion of tax exempt United States obligations from the calculation of a bank's net worth on a pro rata basis with the liabilities incurred to obtain them. The second case is Missouri ex rel Missouri Ins. Co. v. Gehner, 381 U.S. 233 (1930), which the Court in First Nat. Bank v. Barstow Cty. Tax Assrs., *supra*, held "has no vitality today." 470 U.S. at 591.

The cases cited by the defendant do not provide authority for the constitutional parameters governing the state tax arrangement at issue here. These cases do, however, provide a pattern of analysis which is helpful to the resolution of this case. As was summarized in First Nat. Bank v. Barstow Cty. Tax Assrs., *supra*: "In sum, ever since Gehner, each time this Court has addressed the scope of the tax exemption for Government obligations, it has concluded that the exemption need not be a total exclusion, but, instead, may be limited by charging tax exempt obligations and interest their fair share of *related* expenses and burdens." *Id.* at 593 (emphasis added). In other words, the Court has taken a symmetrical view of taxation: income and expenses are paired so that if a

Governmental National Mortgage Association 611 F.2d. 1229, 1232 (1979);) see Shelly v. Kraemer, 334 U.S. 1, 12 (1948). The state fourteenth amendment due process limitations on unitary tax allocations are protections from taxation by a government which is not connected with the activity generating the earnings. Obviously this concept does not apply to a national federal government.

taxpayer need not include certain income in its taxable income, it cannot deduct expenses related to generating that non-included income from its taxable income.

Such logic is precisely what the California Supreme Court recognized in its concern over tax loopholes in Pacific Telephone:

"Although dividends received by a nondomiciliary like American are not taxable in California, it is not true that such dividends are totally unrelated to California. As pointed out above in connection with the discussion of the possible loophole, a foreign corporation should not be permitted to borrow money and build up its interest expense deduction and then receive tax exempt dividends on the basis of investments made with the borrowed money. California has a substantial interest in making sure that income attributable to this state is not distorted by the use of the interest expense deduction, and under subsection (b) [of Rev. & T.C. § 24344] the dividends received are only taken into account to offset the interest expense deduction." 7 Cal. 3d at 556.

Although not so articulated by the Court in Pacific Telephone, this analysis would seem to satisfy the constitutional due process requirements that a taxing state must have "some definite link, some minimum connection" with the property it seeks to tax. Allied Signal, Inc. v. Director, Division of Taxation, *supra*, 768 U.S. at 777. If money were borrowed in California to pay for securities generating income not taxable in California, then California would seem to have a sufficient link to the investment

transaction to close the loophole and prevent windfall deductions for interest expense.

Rev. & T.C. § 24344(b), however, is not so targeted. It disallows interest deductions on a dollar-for-dollar basis with non-taxable dividend income without regard to whether or not such interest is *related to* the dividend income. In that regard, it bears a striking similarity to the Georgia tax statute that was originally considered by the United States Supreme Court in First Nat. Bank v. Barstow Cty. Tax Assrs., *supra*, 470 U.S. 583. As originally presented to the Court, the Georgia statute might have been interpreted to prohibit the exclusion of all tax exempt United States obligations from the calculation of a bank's net worth. Upon that possibility, the Court remanded the case back to the Georgia Supreme Court in order to allow it to interpret its own state statute. On remand, the Georgia Supreme Court "sought to save the statute by construing it to allow a bank to deduct from its net worth 'the percentage of assets attributable to federal obligations'." *Id.* at 587. It was this reconsidered interpretation that was upheld by the Supreme Court. *Id.* at 596-97.

Synthesizing the foregoing, it would appear that Rev. & T.C. § 24344(b) runs afoul of defendant's authorities to the extent that it does not permit the deduction of interest expense not related to the generation of the taxpayer's nontaxable dividend income. Put differently, even given the possibility of a legitimate California state interest in closing the loophole recognized in Pacific Telephone, the statute is overly broad in that it goes far beyond such potential legitimate state purpose. This point is underscored in this case because here the parties have

stipulated that no portion of the proceeds of the loans generating the interest expense deductions herein went to any non-unitary corporation, each of which was responsible for its own borrowings. (J.S. ¶ 9). Thus, it appears that no portion of the interest expense deduction can be attributable to the generation of the interest exempt dividends.

Accordingly, Rev. & T.C. § 24344(b) results in a taking of plaintiff's property without due process of law and is thus in violation of the Fourteenth Amendment to the United States Constitution..

2. The Commerce Clause

Plaintiff's next argument is that Rev. & T.C. § 24344(b) violates the Commerce Clause of the United States Constitution. Plaintiff's argument is that the dollar-for-dollar offset against nontaxable income applies only to dividends of foreign corporations and is thus a Constitutionally impermissible burden on interstate commerce. Defendant asserts that on its face, the statute does not call for a different treatment of interest expense of foreign corporations and that at most the statute discriminates against the character of income (i.e. business vs. nonbusiness) rather than upon taxpayer domicile.

The Commerce Clause to the United States Constitution provides that "the Congress shall have the power to regulate Commerce among the several states." U.S. Const., Art. I, § 8, cl. 3. The Commerce Clause has long been interpreted to have a "negative commerce clause" that precludes the states from unjustifiably discriminating against interstate commerce. Oregon Waste Systems,

Inc. v. Department of Environmental Quality of Oregon, 511 U.S. 93, 98-99 (1993). This negative commerce clause prohibits economic protectionism, i.e., using regulatory or taxing measures to benefit in-state economic interests by burdening out-of-state competitors. Fulton Corp. v. Faulkner, ___ U.S. ___, 116 S.Ct. 848, 853 (1996).

In the area of state taxation, it is well established that a state might further a legitimate state interest with a taxing scheme that discriminates against interstate commerce, but only where the effects thereof upon interstate commerce are just incidental. City of Philadelphia et al v. New Jersey, et al, 437 U.S. 617, 6623-24 (1978). Without a legitimate state interest being furthered, however, it is clear that a state may not tax a transaction or incident more heavily simply because there is an interstate element to it; such laws are "virtually per se invalid." Fulton Corp. v. Faulkner, *supra*, at 854; Armco, Inc. v. Hardesty, Tax Commissioner of West Virginia, 467 U.S. 638, 644-46.⁵

Applying these rules to this case, it is clear that Rev. & T.C. § 24344(b) violates the negative commerce clause of the United States Constitution. The starting point in this analysis is whether the provisions requiring that interest deductions be offset against nontaxable income discriminate against foreign taxpayers. The several examples provided by the parties demonstrate that the offset provisions treat two corporations in an identical business

⁵ The "virtually per se" language reflects an exception which allows a state to require that an interstate transaction bear economic tax burdens already borne by intrastate transactions. Fulton Corp. v. Faulkner, *supra*, at 853, and cases cited therein. This exception does not apply in this case.

transaction differently based solely on their states of domicile, which difference results in increased taxes for foreign corporations. See Tables III and IV in Pacific Telephone, *supra*, at pp.552-53⁶

The defendant asserts that the *tax* in question here is nondiscriminatory. Defendant argues that if anything it is the deductions that distinguish, and those differentiate not on the domicile of the taxpayer but on whether income is nontaxable (hence must be offset against otherwise allowable interest deduction). Such linguistic analysis ignores the impact of the words being dealt with. No matter how one expresses the concept, the amount of tax on a foreign corporation under Rev. & T.C. §24344(b) will be higher than that of a domestic corporation where both have a) the same taxable business income; b) the same interest expense deductions; and c) the same dividend income. The constitutionality of such a result cannot possibly be determined by the statutory words used to create it, i.e. whether the discriminatory tax burden was caused by a "tax" or a "reduction of deduction due to nontaxable income". See, for example, Camps Newfound/Owatonna, Inc. v. Town of Harrison, et al, ___ U.S. ___, 97 Daily Journal D.A.R. 6299 (1997), where an exemption for charitable institutions from an otherwise generally applicable state property tax which excluded organizations which operated principally for the benefit of nonresidents was held to violate the negative commerce clause; Darnell &

⁶ In addition, there is some support for the view that Rev. and T.C. §24344 was expressly designed to increase taxes on foreign corporations while reducing those of domestic corporations. See Pacific Telephone at p. 554..

Son v. Memphis, 208 U.S. 113 (1908), where Tennessee tax exemptions for in state harvested logs but not out of state harvested logs was deemed an impermissible burden on interstate commerce.

The next step in the analysis would be to determine whether California was furthering a legitimate state purpose which, if identified, might justify the differentiated treatment so long as the impact on interstate commerce was merely incidental. This step does not get off the ground. As is stated in the Due Process discussion above, Rev. & T.C. §24344(b) is overbroad and as applied to this case does not further a legitimate state purpose. As such, it is irrelevant as to whether the impact on interstate commerce is incidental or not.

Therefore, Rev. & T.C. §24344(b), which discriminates against the interstate element of foreign corporation's receipt of nontaxable dividend income outside of California violates the Commerce Clause of the United States Constitution.

3. The Equal Protection Clause

Plaintiff next argues that Rev. & T.C. § 24344(b) violates the Equal Protection Clause of the United States Constitution by impermissibly creating an arbitrary and irrational classification based on the domicile of a corporate taxpayer. Defendant asserts that the language of the statute contains no classification based on domicile and, in any event, the statutory scheme is rational in that it is designed to allow deductions of only expenses which correspond to income taxable in California.

In the area of state taxation, the Equal Protection Clause⁷ precludes a state from imposing more onerous taxes or other burdens on foreign corporations than those imposed on domestic corporations, unless the discrimination between foreign and domestic corporations bears a rational relationship to a legitimate state purpose. Metropolitan Life Ins. Co. v. Ward, 470 U.S. 869, 875 (1985) [holding that the promotion of domestic industry is not a legitimate state purpose under due process analysis and rejecting Alabama's other purported interest in its higher tax rate for out of state insurers]; Williams v. Vermont, 472 U.S. 14, 23 (1985) ["A state may not treat those within its borders unequally solely on the basis of their different residences or states of incorporation."].

Applying this analysis to the present case, it is clear that Rev. & T.C. § 24344(b) violates the Equal Protection Clause. Defendant asserts that the legitimate state interest being furthered here is "to allow a deduction of only those expenses relating to an item of income which the state is not barred from taxing." Defendant Franchise Tax Board's Reply Brief, filed herein on March 13, 1997, p. 19-20. As is discussed above, however, Rev. & T.C. § 24344(b) is not so limited and precludes interest deductions to the extent of nontaxable income *irrespective of whether those deductions are related to the nontaxable income*. Since this provision applied unequally to domestic corporations and foreign corporations because only the

⁷ The Equal Protection Clause provides "...nor shall any State...deny to any person within its jurisdiction the equal protection of the laws." United States Constitution, Amendment 14, Sec. 1.

dividend income of the latter are nontaxable in California, the purported state purpose is discriminatory and not rationally related to a legitimate state purpose. As such it violates the Equal Protection Clause of the United States Constitution.⁸

CONCLUSION

Rev. & T.C. § 24344(b) violates the Due Process, Commerce and Equal Protection Clauses of the United States Constitution insofar as it allows for a dollar-for-dollar offset of otherwise deductible interest expenses with nontaxable dividend income of foreign corporate taxpayers. Accordingly, the taxes and interest at issue herein were impermissibly imposed and collected. Plaintiff is therefore entitled to Judgment for \$2,258,020.44 plus interest from May 2, 1997 as calculated under Rev. & T.C. § 19391.

Either party may on or before June 20, 1997 file and serve any objections or proposals hereto. Plaintiff shall prepare a proposed form of Judgment, submit it to the defendant for approval as to form, and present it to the Court on or before June 20, 1997.

Dated: June 6, 1997

Richard A. Kramer
Judge of the Superior Court

⁸ Defendant's further argument that the language of the statute does not discriminate against foreign corporations is rejected in light of the effect of the statute, as is discussed above.

SUPERIOR COURT OF THE STATE OF CALIFORNIA
FOR THE CITY AND COUNTY OF SAN FRANCISCO

DEPARTMENT: 17

HUNT-WESSON, INC., CASE NO. 976628

Plaintiff(s),

v.

CERTIFICATE OF SERVICE
BY MAIL (CCP 1013a(4))

FRANCHISE TAX BOARD,

Defendant(s).

I, Tatsuo Maruyama, a deputy clerk of the Superior Court for the City and County of San Francisco, certify that:

- 1) I am not a party to this action;
- 2) On June 6, 1997, I served the attached;

PROPOSED STATE OF DECISION

by placing a copy thereof in a sealed envelope, addressed as follows:

CHARLES J. MOLL, III,
ESQ.

EDWIN P. ANTOLIN, ESQ.

MORRISON & FOERSTER
425 MARKET ST.
SF., CA. 94105

DAVID LEW, Deputy Atty
General

STATE OF CALIFORNIA
DEPARTMENT OF
JUSTICE
ATTORNEY GENERAL'S
OFFICE
50 FREMONT ST. STE. 300
SF., CA. 94105

and,

3) I then placed the sealed envelope in the outgoing mail at 633 Folsom Street, San Francisco, Ca. 94107 on the date indicated above for collection, attachment of required prepaid postage, and mailing on that date following standard court practices.

Dated: JUNE 6, 1997

ALAN CARLSON, Clerk

BY: Tatsuo Maruyama, Deputy
Tatsuo Maruyama
Clerk in Department 17

NOT TO BE PUBLISHED IN OFFICIAL REPORTS
IN THE COURT OF APPEAL OF THE
STATE OF CALIFORNIA
FIRST APPELLATE DISTRICT
DIVISION THREE

HUNT-WESSON, INC.,)	
Plaintiff and Respondent,	)	(Filed Dec. 11,
	)	1998)
v.)	
FRANCHISE TAX BOARD,)	
Defendant and Appellant.	)	A079969
	)	(San Francisco
	)	County
	)	Super. Ct. No.
	)	976628)

The Franchise Tax Board (the Board) appeals from a judgment ordering the refund of over \$2 million in franchise taxes and interest to respondent Hunt-Wesson, Inc. (Hunt-Wesson). The Board contends the trial court erred in holding unconstitutional Revenue and Taxation Code section 24344.¹ We agree, based on our Supreme Court's decision in *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.* (1972) 7 Cal.3d 544 (*Pacific Telephone*), and therefore reverse the judgment.

¹ Subsequent statutory references are to the Revenue and Taxation Code.

Factual and Procedural Background

Respondent Hunt-Wesson is a Delaware corporation, domiciled in Illinois, and engaged in business in California and elsewhere.² During the relevant years, respondent owned, and received dividends from, certain nonunitary subsidiaries, none of which were incorporated in California and most of which were incorporated under the laws of a foreign country. The dividends constituted nonunitary, nonbusiness income and were not subject to apportionment, or taxation, by California.³ Respondent made no direct operating loans to the subsidiaries during the relevant years.

Respondent claimed deductions for certain business interest expenses on its California franchise tax returns. Following an audit, the Board disallowed the deductions, dollar for dollar, to the extent the dividends were received from nonunitary subsidiaries, pursuant to the interest offset provision of section 24344. Respondent paid the proposed deficiencies⁴ and filed a timely claim for refund. The case was submitted on stipulated facts, and the trial court ruled that section 24344 violates the Due Process, Equal Protection, and Commerce Clauses of

² The facts are summarized from the parties' Joint Stipulation of Facts. Hunt-Wesson is a successor in interest to Beatrice Companies, Inc. and Beatrice Foods Company, also Delaware corporations domiciled in Illinois.

³ The dividends were taxable by Illinois, respondent's state of domicile.

⁴ Respondent also agreed to permit the Board to credit an overpayment against the proposed deficiencies.

the United States Constitution. This appeal followed an order of refund below.

Issue on Appeal

Whether the interest offset provision of section 24344 is unconstitutional is a question of law over which this court exercises independent review. (*GTE Sprint Communications Corp. v. State Bd. of Equalization* (1991) 1 Cal.App.4th 827, 832.) "The power of the Legislature in the area of taxation is paramount, and any constitutional restriction on that power must be strictly construed against the limitation. [Citation.]" (*Franchise Tax Bd. v. Superior Court* (1989) 212 Cal.App.3d 1343, 1347.) Every statute is presumed constitutional (*County of Sonoma v. State Energy Resources Conservation etc. Com.* (1985) 40 Cal.3d 361, 368), and must be upheld unless it is " 'clearly, positively, and unmistakably' " unconstitutional. (*Calfarm Ins. Co. v. Deukmejian* (1989) 48 Cal.3d 805, 814.) Any doubt must be resolved in favor of the legislation; even if its validity is "fairly debatable," it must nonetheless be sustained. (*Id.* at pp. 814-815.)

When a corporation derives income from sources both within and outside the state, California's corporate franchise tax is measured by net income attributable to in-state sources. (§§ 23151, 25101.) California follows the Uniform Division of Income for Tax Purposes Act (UDITPA) (§ 25120 et seq.), which makes a distinction between business and nonbusiness income.⁵ Business

⁵ Business income is defined as "income arising from transactions and activity in the regular course of the taxpayer's

income is generally calculated by applying an apportionment formula based on sales, property and payroll to the corporation's unitary business income. (§ 25128.) Non-business dividend income is not apportioned, but is taxable by the corporation's state of domicile. (§§ 25123, 25126.)

In calculating taxable net income under the apportionment approach, section 24344 provides for the deduction of interest expense, subject to certain limitations.⁶ Pursuant to subsection (b), interest expense is fully deductible to the extent of business interest income. Additional interest expense is then offset against non-business interest and dividend income (which is not subject to allocation by formula), with the remaining interest

trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." (§ 25120, subd. (a).) Nonbusiness income is "all income other than business income." (§ 25120, subd. (d).)

⁶ For the relevant years, former section 24344 provided: "(a) Except as limited by subsection (b), there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer. [¶] (b) If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula."

deductible. Applying this section, the Board disallowed Hunt-Wesson's interest expense deduction on a dollar-for-dollar basis to the extent it received dividends from its nonunitary subsidiaries. Hunt-Wesson claims the application of the interest offset provision violates the Due Process and Commerce Clauses because it indirectly taxes nonbusiness dividends which could not be taxed directly, and discriminates against corporations domiciled outside California. Hunt-Wesson also argues the statute violates the Equal Protection Clause by creating an irrational classification that discriminates solely on the basis of a corporation's state of domicile.

Division One of this court recently noted that "[t]he theory of this interest offset rule is that a corporation should not be able to borrow money to purchase stocks that pay dividends and then get a deduction for the interest while the dividend income (being investment or nonbusiness income) is not taxable. [Citation]." (*Willamette Industries, Inc. v. Franchise Tax Bd.* (1995) 33 Cal.App.4th 1242, 1246-1247 (*Willamette*).) The *Willamette* court relied on our Supreme Court's ruling in *Pacific Telephone*, *supra*, 7 Cal.3d at page 554, which continues to bind us here.⁷

In *Pacific Telephone*, *supra*, the Supreme Court held that the Legislature had acted reasonably by treating interest expense as the opposite of dividend income, and by requiring the offset of the one against the other. (7

⁷ The *Willamette* court ultimately concluded the interest offset rule did not apply in that case, because the dividends were business income, which is apportioned. (*Supra*, 33 Cal.App.4th at pp. 1246, 1250.) That issue is not present here.

Cal.3d at pp. 551-552.) The high court rejected the taxpayer's argument that the offset should apply only to taxable dividend income. (*Id.* at pp. 553-556.) The court noted that the dividend income of a foreign corporation is not taxable in California, but concluded it comes within the language and logic of the offset statute, which is designed to offset interest expense against investment income.⁸ (*Id.* at pp. 552-554.) The court noted that otherwise a tax loophole would be created, and that "a foreign corporation should not be permitted to borrow money and build up its interest expense deduction and then receive tax exempt dividends on the basis of investments made with the borrowed money." (*Id.* at p. 556.)

The Supreme Court held that inclusion of nontaxable dividends in the statutory offset computation did not constitute taxation of the dividends themselves, which were reasonably used to offset the interest expense deduction. (*Pacific Telephone*, *supra*, 7 Cal.3d at p. 555.) The court noted that "California has a substantial interest in making sure that income attributable to this state is not distorted by use of the interest expense deduction, and under subsection (b), the dividends received are only taken into account to offset the interest expense deduction." (*Id.* at p. 556; see also *Lyon Metal Products, Inc. v. State Bd. of Equalization* (1997) 58 Cal.App.4th 906, 913-914 (*Lyon*) [Legislature validly closed sales tax loophole by

⁸ At the time of the *Pacific Telephone* decision, dividends of a foreign corporation were not taxable based on the doctrine of *mobilia sequuntur personam* ([movables follow the person]). (*Supra*, 7 Cal.3d at p. 552.) Under current tax law, that doctrine has been replaced by the business/nonbusiness distinction discussed above.

adding drop shipment rule to reach transactions through out-of-state intermediaries, per Division Five of this District]; *Armour & Co. v. Wisconsin Department of Taxation* (1948) 32 N.W.2d 324, 326 [upholding similar restriction on interest deduction as constitutional].⁹

Hunt-Wesson contends that the interest offset provision of section 24344 impermissibly taxes dividends which are constitutionally immune from taxation by California, and therefore violates the federal Due Process Clause. The Due Process Clause limits a state's power to impose a tax on an activity which is not connected with the taxing state. (*Allied-Signal, Inc. v. Director, Div. of Taxation* (1992) 504 U.S. 768, 777-778.) Thus a state may not constitutionally tax income dividends which a non-domiciliary corporation receives from subsidiary corporations having no other connection with the state. (*ASARCO, Inc. v. Idaho State Tax Comm'n* (1982) 458 U.S. 307, 327-329.)

Hunt-Wesson argues that the interest offset provision of section 24344 constitutes an indirect tax on immune

⁹ In explaining its reasons for declining to limit the coverage of subdivision (b) to taxable dividends in *Pacific Telephone, supra*, the Supreme Court listed as an additional factor the language of the section itself, which is phrased as a limitation on the deduction of interest expense. The court noted this view was reinforced by a letter sent from the Board to Governor Knight, before he signed the legislation, stating the provision would increase taxes on foreign corporations while reducing those of domestic corporations. (7 Cal.3d at p. 554.) Despite that potential indirect effect on foreign corporations, the Supreme Court upheld the interest offset provision, determining that it did not constitute a tax. (*Id.* at p. 555.)

income, increasing a nondomiciliary corporation's tax liability solely because it receives nontaxable dividends. Hunt-Wesson also argues that the interest offset is overbroad, because it fails to apportion interest expense, but creates a dollar-for dollar offset. If we were writing on a clean slate, these arguments might appear persuasive. In *Pacific Telephone, supra*, however, the California Supreme Court explicitly held that inclusion of nontaxable dividends in the statutory offset computation under section 24344 does not constitute taxation of the dividends themselves. (7 Cal.3d 544.) We defer, as we must, to that decision. (*Auto Equity Sales, Inc. v. Superior Court* (1962) 57 Cal.2d 450, 455.)

Although, as Hunt-Wesson points out, the *Pacific Telephone* case did not involve a constitutional challenge to section 24344, our Supreme Court clearly recognized the dividend income itself was not taxable in California, while upholding the interest offset provision of section 24344. (*Supra*, 7 Cal.3d at pp. 549, 552.) Hunt-Wesson's argument that *Pacific Telephone* is "an outdated, obsolete case" must be addressed to courts of superior jurisdiction to our own.¹⁰

¹⁰ Hunt-Wesson also argues the language in *Pacific Telephone* is dictum, because the taxpayer, being domiciled in California, did not contest the inclusion of the nonbusiness dividends in the interest offset provision. The taxpayer in *Pacific Telephone*, however, was a member of a unitary business (most of whose members were domiciled outside California) whose California tax liability was greater than it would have been without the application of section 24344 (*supra*, 7 Cal.3d at p. 546), because interest expense, which would otherwise have been an apportionable business expense of the entire unitary business, was assigned to non-California domiciliaries. After the tax year

Hunt-Wesson also contends the interest offset statute is unconstitutional because it discriminates against interstate commerce in violation of the Commerce Clause. First, Hunt-Wesson argues section 24344 denies the interest deduction only to non-California corporations, imposing a facially discriminatory tax which is "virtually per se invalid." This argument again collides with our Supreme Court's holding in *Pacific Telephone* that the interest offset provision does not constitute a tax on the dividends in question. Moreover, the cases on which Hunt-Wesson relies are distinguishable. In *Fulton Corp. v. Faulkner* (1996) 516 U.S. 325, for example, the intangibles tax involved was discriminatory on its face, taxing stockholders only to the degree that the issuing corporation participated in interstate commerce, and the only real issue was whether the deduction in question could be sustained as compensatory. (*Id.* at pp. 333-334.) Here, by contrast, the alleged favorable effect on local commerce is indirect and incidental. Section 24344, which is part of an overall apportioned tax scheme, does not distinguish between domestic and foreign corporations, and the same rules and logic of offsetting interest expense against investment income are applied to both. (See *Pacific Telephone, supra*, 7 Cal.3d at p. 558.) Deductibility of interest

there in issue, the Legislature eliminated unitary intercompany dividends from the tax base and the subsection (b) computation. (*Id.* at p. 558, fn. 11.) The Legislature did not, however, similarly adjust the treatment of non-unitary dividends, which are at issue here. We are unable to distinguish *Pacific Telephone* on any principled basis. Because we conclude the fact asserted by Hunt-Wesson does not serve to distinguish the case, *Pacific Telephone's* holding dictates the outcome here.

expense is determined not by the corporation's domicile, but by the character of the income attributable to that expense.¹¹

Thus the facial discrimination cases (with their concomitant rule of virtual per se invalidity) upon which respondent relies are not determinative. (See, e.g., *Camps Newfound/Owatonna, Inc. v. Town of Harrison* (1997) 520 U.S. 564, 572-583 [reduction of state property tax exemption for charities operated principally for benefit of non-residents was facially discriminatory and thus invalid]; *Oregon Waste Systems, Inc. v. Department of Environmental Quality of Ore.* (1994) 511 U.S. 93, 99-100 [surcharge on disposal of waste generated out of state was discriminatory on its face, triggering rule of virtual per se invalidity]; *Philadelphia v. New Jersey* (1978) 437 U.S. 617, 623-629 [New Jersey law banning waste imported from other states violated Commerce Clause].) In the absence of a directly applicable ruling by the federal Supreme Court holding unconstitutional an interest offset provision such as the one in issue here, we remain bound by *Pacific Telephone, supra*. In fact, respondent has not cited, and our research has not uncovered, any decision, federal or state, holding such a provision unconstitutional.

¹¹ The Board points out that domicile is not necessarily the operative component in determining where nonbusiness income is taxable. (See § 25125, subd. (d) [allocation of gain or loss on sale of partnership interest allocable by ratio based on original cost of partnership tangible property both in and out of state]; § 25127 [patent and copyright royalties allocable to extent utilized in state].)

Hunt-Wesson also argues section 24344 unlawfully discriminates by excluding from the interest offset computation under section 24402 dividends declared from income previously taxed by California. Hunt-Wesson contends this exclusion favors investment in California subsidiaries over investment in subsidiaries not doing business in California. Because California has previously taxed the income in question, however, we discern no unconstitutional discrimination in the state refraining from double taxation. (See *Pacific Telephone, supra*, 7 Cal.3d at p. 548, fn. 4.) Unlike *Fulton, supra*, on which respondent relies, the statute does not waive an otherwise uniform intangibles tax, based simply on the percentage of the underlying corporate income taxed by the state. Instead, it operates as part of an overall apportioned tax scheme, matching expenses with income in a manner which our Supreme Court has determined to be reasonable. (*Pacific Telephone, supra*, 7 Cal.3d at pp. 551-552, 555.)

The parties also disagree as to the application of the "internal consistency" test here. (See *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.* (1995) 514 U.S. 175, 185.) "Internal consistency is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear." (*Ibid.*) The Board contends that section 24344 does not affect respondent's overall tax liability, because if all the states in which it is taxable adopted similar provisions, respondent's taxable income in Illinois would decrease in proportion to the amount its taxable income in California would increase.

Respondent disagrees, also asserting that internal consistency is not sufficient. We need not decide this theoretical point, because the "internal consistency" standard is applicable only to taxes, and our high court has held the interest offset provision is not a tax on the income in question here. (*Pacific Telephone, supra*, 7 Cal.3d at p. 555.) Moreover, the United States Supreme Court has held that the Commerce Clause does not require absolute precision in interstate taxation, noting that the States have adopted differing rules regarding business and nonbusiness income and their attribution for apportionment purposes. (*Moorman Mfg. Co. v. Bair* (1978) 437 U.S. 267, 278-281 [rejecting argument that Commerce Clause prohibits any overlap in computation of taxable income by the States].)

Nor does the interest offset provision deprive appellants of their equal protection rights. Hunt-Wesson concedes that the only inquiry under the Equal Protection Clause is whether there is a rational relationship between the State's classification and its objective. The provision here is rationally related to California's need to close an otherwise gaping tax loophole, as explained in *Pacific Telephone, supra*. Unlike the discriminatory taxes struck down in the cases cited by Hunt-Wesson, section 24344 does not create an arbitrary classification based solely on state of domicile. (Compare *Williams v. Vermont* (1985) 472 U.S. 14, 23 [discriminatory exemption from use tax based solely on state of residence did not serve legitimate state purpose]; *Metropolitan Life Ins. Co. v. Ward* (1985) 470 U.S. 869, 878 [state may not promote domestic business by

taxing foreign corporations at a higher rate solely because of their residence].)¹²

Disposition

The judgment below is reversed. The matter is remanded to the trial court with directions to enter judgment for the Board.

Corrigan, J.

We concur:

Phelan, P.J.

Walker, J.

A079969, *Hunt-Wesson, Inc. v. Franchise Tax Board*

¹² Respondent asserts that the legislative history of section 24344 indicates it was enacted to benefit California corporations, apparently referring to the letter from the Board to Governor Knight mentioned in *Pacific Telephone, supra*, 7 Cal.3d at p. 554. While the letter reportedly stated the provision would increase taxes on foreign corporations while reducing those on domestic corporations, the Board points out here that the letter indicates no intent to discriminate against foreign corporations but merely notes the likely consequence of section 24344 which results from plugging the tax loophole. This is a permissible subject of legislation. (See *Lyon, supra*, 58 Cal.App.4th at pp. 913-914.)

First Appellate District, Division Three, No. A079969
S076104

IN THE SUPREME COURT OF CALIFORNIA

HUNT-WESSON INCORPORATED, Respondent

v. (Filed MAR. 24, 1999)

FRANCHISE TAX BOARD, Appellant

Respondent's petition for review DENIED.
The request for an order directing publication of the opinion is denied.

Kennard, J., is of the opinion the petition for review should be granted.

GEORGE
Chief Justice

7

No. 98-2043

Supreme Court, U.S.

FILED

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In The
Supreme Court of the United States

—◆—
HUNT-WESSON, INC.,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

—◆—
**On Writ Of Certiorari
To The Court Of Appeal Of California
For The First Appellate District**
—◆—

BRIEF FOR PETITIONER
—◆—

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QUESTIONS PRESENTED

1. Under the Commerce and Due Process Clauses, a State may not tax the dividends that a nondomiciliary corporation receives from its nonunitary subsidiaries. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992); *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F.W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354 (1982). California law nevertheless requires that a nondomiciliary corporation reduce its deductible net interest expense – and thereby increase its apportionable income subject to tax – by the amount of such exempt dividends. Moreover, this requirement applies even when the disallowed interest expense is unrelated to the production of the exempt dividend income. The question presented is:

Whether a State may tax constitutionally exempt income under the guise of denying a deduction for expenses in an amount equal to such income when there is no evidence that the expenses relate to the production of the exempt income?

2. Whether a State tax discriminates against interstate commerce in violation of the Commerce Clause by disallowing an otherwise deductible expense, thereby increasing California taxable income, solely because the corporation is not domiciled in the State or does not have subsidiaries that engage in taxable in-state activity?

LIST OF PARTIES

The parties are as stated in the caption. In the courts below, the petitioner was referred to as Hunt-Wesson, Inc., Successor in Interest to Beatrice Companies, Inc., and as Hunt-Wesson, Inc., formerly known as Beatrice/Hunt-Wesson, a Successor by Merger with Beatrice Company, formerly known as CagSub, Inc., a Successor in Interest to Beatrice Companies, Inc., formerly known as Beatrice Foods Company.

RULE 29.6 STATEMENT

Hunt-Wesson, Inc. is a wholly owned subsidiary of ConAgra, Inc. Its non-wholly-owned subsidiaries are ConAgra Brands, Inc. and ConAgra Limited.

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OPINIONS BELOW

The Opinion of the Court of Appeal (J.A. 54-66)¹ is not officially reported. The judgment and statement of the Superior Court of California, City and County of San Francisco (J.A. 33-53), is not officially reported. The California Supreme Court's denial of Hunt-Wesson's petition for review (J.A. 67) is not officially reported.

JURISDICTION

The judgment of the Court of Appeal was entered on December 11, 1998. The Supreme Court of California denied Hunt-Wesson's petition for review on March 24, 1999. J.A. 67. The petition for certiorari was filed on June 22, 1999, and was granted on September 28, 1999. The jurisdiction of this Court rests on 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, U.S. Const. art. I, § 8, cl. 3, provides: "The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

¹ References to the Joint Appendix are denominated "J.A." followed by a page reference. References to the Appendix to the Petition for Certiorari are denominated "Pet. App." followed by a page reference.

The Due Process Clause of the Fourteenth Amendment to the United States Constitution, U.S. Const. amend. XIV, § 1, provides: "No State shall . . . deprive any person of life, liberty, or property, without due process of law."

Relevant portions of the California statutes are set forth at Pet. App. 35a-38a.

STATEMENT

This case involves a dispute over California's denial of an income tax deduction to nondomiciliary corporations. California's corporate income tax law generally provides that "there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer." Cal. Rev. & Tax. Code § 24344(a). However, through its so-called "interest offset" provision, California modifies this general principle for nondomiciliary corporations in a manner that is constitutionally indefensible for three discrete reasons.

First, California denies nondomiciliary corporations an interest expense deduction in an amount equal to constitutionally nontaxable dividends. California denies this deduction even when the disallowed interest expense bears no relationship to the constitutionally nontaxable dividends. As a consequence, California increases a nondomiciliary corporation's taxable income base by an amount equal to the nontaxable income, effectively taxing income that lies beyond California's constitutional reach.

Second, California permits domiciliary corporations, but not nondomiciliary corporations, to reduce their taxable income by interest expense to the extent that the corporation receives dividends from nonunitary corporations. The preferential treatment persists regardless of whether the interest expense bears any relationship to the production of the dividends in question. Because the allowance or disallowance of the deduction turns entirely on the domicile of the dividend-receiving corporation, it violates the cardinal principle of this Court's Commerce Clause jurisprudence barring taxes that facially discriminate in favor of in-state over out-of-state entities.

Third, California provides a selective exception to the rule denying nondomiciliary corporations an interest expense deduction: It permits a nondomiciliary corporation to deduct interest expense without regard to its receipt of constitutionally nontaxable dividends, but *only* if the dividends are received from corporations that engage in taxable activity in California. This limited exception to the rule disallowing nondomiciliary corporations an interest expense deduction, however, runs headlong into the Commerce Clause prohibition against state taxes that condition a tax benefit (the deductibility of interest expense) upon the extent of a corporation's in-state investment.

In short, California's attempt to curtail the availability of its interest expense deduction to nondomiciliary corporations is riddled with constitutional defects, any one of which is sufficient to require its invalidation.

1. Beatrice's Business

The facts of this case, which have been stipulated, are not in dispute.² Petitioner Hunt-Wesson, Inc. is the successor in interest to the Beatrice Foods Company ("Beatrice"), the original taxpayer in this case. Beatrice was a Delaware corporation with its commercial domicile in Illinois. During the years at issue (fiscal years 1980 through 1982),³ Beatrice was a diversified company engaged in business within and without California, primarily in providing food and food-related products and services for worldwide markets. Beatrice also produced other consumer, industrial, and chemical products.

Beatrice owned directly and indirectly certain dividend-paying subsidiaries with which it was not engaged in a unitary business (the "nonunitary subsidiaries"). Stip. ¶ 7 (J.A. 19). Most of the nonunitary subsidiaries were incorporated in foreign countries, and none of them was incorporated in California. Stip. ¶ 7 (J.A. 19). The nonunitary subsidiaries paid to Beatrice dividends which were not taxable by California (the "nonunitary dividends") of \$26,718,620 for 1980, \$29,482,637 for 1981, and \$19,022,617 for 1982. Stip. ¶¶ 7, 8 (J.A. 19).

² References to the Joint Stipulation of Facts in this case are denominated "Stip." followed by a paragraph reference. The Joint Stipulation of Facts is reproduced at J.A. 16-24.

³ The three fiscal years at issue date from March 1, 1979 to February 29, 1980; March 1, 1980 to February 28, 1981; and March 1, 1981 to February 28, 1982. For ease of reference, we will refer to these years in the text simply as "1980," "1981," and "1982," respectively.

In the operation of its business, Beatrice took out loans and incurred interest expense in connection with these loans. Trial Court Statement of Decision ¶ F (J.A. 35). During the years at issue, the outstanding loans amounted to \$793,683,348 for 1980, \$610,230,945 for 1981, and \$1,312,660,515 for 1982. Stip. Exh. 1 (Clerk's Transcript ("CT") pp. 64-66). The interest expense with respect to these loans amounted to \$80,490,469 for 1980, \$55,101,503 for 1981, and \$137,413,162 for 1982. Stip. ¶ 10 (J.A. 19); Stip. Exh. 1 (CT pp. 64-66). It has never been disputed in this case that "no portion of the proceeds of the loans generating the interest expense deductions herein went directly to any non-unitary corporation, each of which was responsible for its own borrowings (J.S. [Stip.] ¶ 9)." Franchise Tax Board's Objection to Proposed Statement of Decision and Request for Hearing on Objection (CT p. 295) (emphasis omitted). Accordingly, Beatrice claimed a deduction for such interest expense on its California franchise tax returns. Stip. ¶¶ 10, 11, 13 (J.A. 19-20).

2. California's Taxing Scheme

California imposes a franchise tax measured by net income on corporations for the privilege of doing business in California. Cal. Rev. & Tax. Code §§ 23151, 23151.1. For a corporation like Beatrice, which is engaged in business within and without the State, California divides the corporation's income into two categories: business income and nonbusiness income. Business income, which is apportioned by formula among all the

States in which the taxpayer does business,⁴ means "income arising from transactions and activity in the regular course of the taxpayer's trade or business. . . ." Cal. Rev. & Tax. Code § 25120(a). Nonbusiness income, which generally is allocated to a particular State depending on its situs, "means all income other than business income." Cal. Rev. & Tax. Code §§ 25120(d), 25123-25127.

These definitions are generally "quite compatible with the unitary business principle." *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 786 (1992). Under this principle, a State may tax an apportioned share of a nondomiciliary taxpayer's income arising from its unitary business, but generally may not tax income that is not connected with its unitary business (for example, dividend income received from nonunitary subsidiaries).⁵ It is stipulated in this case that "[a]ll of th[e] nonunitary dividends received by Beatrice constituted nonunitary, nonbusiness income not subject to apportionment, or taxation, by the State of California." Stip. ¶ 8 (J.A. 19).

⁴ The formula determines the portion of the corporation's business income that is fairly attributable to California. During the years at issue, the apportionment percentage was the simple average of three fractions – the taxpayer's in-state property over its total property, its in-state payroll over its total payroll, and its in-state sales over its total sales. See Cal. Rev. & Tax. Code §§ 25128, 25129, 25132, and 25134.

⁵ If the nonbusiness income has its situs in the State, e.g., income from real property located in the State but unrelated to the taxpayer's trade or business, then the State may, of course, tax a nondomiciliary taxpayer's income from such property. See, e.g., Cal. Rev. & Tax. Code § 25124.

California law generally provides that "there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer." Cal. Rev. & Tax. Code § 24344(a). Any interest expense attributable to business income must be subtracted from such income, thereby reducing the income subject to apportionment, and any interest expense attributable to non-business income must be subtracted from such income, thereby reducing the income subject to allocation. See Stip. ¶ 11 (J.A. 20). This reflects the widely accepted principle of income tax law and practice generally and in California that expenses should be allocated to the category of income to which they are properly attributable. See Cal. Rev. & Tax. Code § 24425; *Great W. Fin. Corp. v. Franchise Tax Bd.*, 4 Cal. 3d 1, 6, 479 P.2d 993 (1971), quoting 12 Marshall, Cal. Practice, State and Local Taxation (1969). There is no dispute in this case about the propriety of this principle.

Rather, the dispute in this case centers on California's so-called "interest offset" provision, contained in Cal. Rev. & Tax. Code § 24344(b), which, during the years at issue, provided:

If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend

income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula.

Cal. Rev. & Tax. Code § 24344(b).⁶

For a nondomiciliary taxpayer like petitioner, its interest expense deduction is computed in the following manner.⁷ First, as a preliminary matter, the taxpayer must attribute its interest expense to business income or non-business income. Only the former – the “business interest expense” – is subject to the interest offset provision.⁸ Second, the taxpayer may deduct its business interest expense to the extent that it has business interest income. Third, the taxpayer must “offset” or reduce the remaining net business interest expense on a dollar-for-dollar basis to the extent of its nonbusiness dividend and interest income, none of which is taxable by California.⁹ However, the taxpayer retains the right to the interest expense

⁶ The current version of Cal. Rev. & Tax. Code § 24344(b), which is substantially the same as the version in force during the years at issue here, reflects amendments that are not material to this case.

⁷ The operation of the interest offset for domiciliary taxpayers is described *infra* at 33.

⁸ As the stipulation provides:

Before the “interest offset” computation was made . . . nonbusiness interest expense . . . was deducted from total interest expense Thus, the remaining interest expense . . . was business interest expense subject to the “interest offset” computation.

Stip. ¶ 11 (J.A. 20).

⁹ *Allied-Signal*, 504 U.S. 768; *ASARCO, Inc. v. Idaho State Tax Comm’n*, 458 U.S. 307 (1982); *F.W. Woolworth Co. v. Taxation & Revenue Dep’t*, 458 U.S. 354 (1982); Stip. ¶ 8 (J.A. 19).

deduction, if, but only if, those nonbusiness dividends are received from a corporation deriving taxable income from (and thus doing business in) California.¹⁰ Fourth, if any net business interest expense remains after having been reduced by the amount of the nontaxable, nonbusiness dividends and interest, the taxpayer may deduct such remaining interest expense against its taxable business income.

The operation of this scheme, as described in the preceding paragraph, may be illustrated as follows:

Step 1:	Total Interest Expense
Less	Nonbusiness Interest Expense
	<u>Business Interest Expense</u>
Step 2:	Business Interest Expense
Less	Business Interest Income
	<u>Net Business Interest Expense</u>
Step 3:	Net Business Interest Expense
Less	Nonbusiness Interest Income and
	Dividends (the “Interest Offset”)*
	<u>Remaining Net Business Interest Expense</u>
	<u>after Interest Offset</u>
Step 4:	<u>Remaining Net Business Interest Expense</u>
	<u>after Interest Offset</u>

* Interest expense equal to these amounts is disallowed as a deduction (except dividends paid by corporations taxable in California).

¹⁰ See Cal. Rev. & Tax. Code § 24344(b) (providing for interest offset against nonbusiness dividends “except dividends deductible under the provisions of Section 24402”). Dividends deductible under Cal. Rev. & Tax. Code § 24402 are dividends declared from income which has been included in the measure of tax in California.

In substance, then, the interest offset provision sets forth two rules disallowing a deduction for interest expense that is otherwise deductible. The first rule denies a nondomiciliary corporation the benefit of an interest expense deduction by requiring it to allocate its net interest expense to nontaxable income regardless of whether the interest expense bears any relationship to the production of such income. The second rule denies a nondomiciliary corporation receiving nontaxable dividends the benefit of an interest expense deduction unless those dividends are from subsidiaries doing business in California.

3. The Assessment

During an audit of Beatrice's tax returns for the years at issue, the Franchise Tax Board (the "Board") applied the interest offset provision and disallowed a portion of Beatrice's interest expense deduction for each year. Stip. ¶ 12 (J.A. 20). Beatrice's total interest expense for the years at issue was \$80,490,469 for 1980, \$55,101,503 for 1981, and \$137,413,162 for 1982, all of which was business interest expense. Stip. ¶¶ 10, 11, 13 (J.A. 19-20). Under the interest offset provision, the Board first permitted Beatrice to deduct the portion of its business interest expense equal to its business interest income, which amounted to \$10,217,578 for 1980, \$21,389,332 for 1981, and \$83,920,105 for 1982. CT pp. 93, 120. The Board then disallowed Beatrice a deduction for its net business interest expense on a dollar-for-dollar basis to the extent of the constitutionally nontaxable dividends that Beatrice received from its nonunitary subsidiaries. Stip. ¶ 12 (J.A. 20). Those dividends amounted to \$26,718,620 for 1980, \$29,482,367

for 1981, and \$19,022,617 for 1982, Stip. ¶ 7 (J.A. 19), which therefore resulted in the denial of an interest expense deduction in the same amounts, namely \$26,718,620 for 1980, \$29,482,367 for 1981, and \$19,022,617 for 1982. Stip. ¶¶ 7, 12 (J.A. 19, 20); CT pp. 93, 120.¹¹

The basis for the Board's denial of Beatrice's interest expense deduction was simply that Beatrice had received nonbusiness dividends from its nonunitary subsidiaries. Stip. ¶ 14 (J.A. 21). The Board made no determination that the interest expense bore any relationship to the constitutionally exempt dividends, Stip. ¶ 14 (J.A. 21), and the statute did not require that it do so. As a consequence of the Board's disallowance of Beatrice's interest expense deduction, it increased Beatrice's California business income subject to apportionment by \$26,718,620 for 1980, \$29,482,367 for 1981, and \$19,022,617 for 1982 – the amount of Beatrice's nontaxable dividend income. Stip. ¶ 12 (J.A. 20). This resulted in tax deficiencies of \$139,066 for 1980, \$170,486 for 1981, and \$109,640 for 1982. Stip. ¶ 20 (J.A. 22).

4. The Proceedings Below

In March 1996, Beatrice commenced this action by filing a suit for refund of taxes and interest in the

¹¹ The Board allowed a deduction for Beatrice's remaining business interest expense in excess of its nonbusiness dividend income in the amount of \$43,554,427 for 1980, \$4,229,804 for 1981, and \$34,470,440 for 1982. See, CT pp. 93, 120.

Superior Court, City and County of San Francisco.¹² Verified Complaint for Refund of Taxes ("Complaint") (J.A. 4). Beatrice alleged, among other things, that the interest offset provision violated the Commerce and Due Process Clauses of the United States Constitution¹³ by arbitrarily limiting its interest expense deduction by the amount of its constitutionally nontaxable dividend income. Complaint ¶¶ 21-22 (J.A. 8).

(a) **The Superior Court.** In June 1997, the Superior Court found that the interest offset provision violated the Commerce and Due Process Clauses. Turning first to the Due Process Clause claim, the court grounded its analysis in two basic, and undisputed, principles: first, "that a State may not tax plaintiff's nonbusiness dividends because plaintiff is a foreign nondomiciliary corporation and such income is only taxable in its state of domicile"; second, "that a state cannot tax indirectly that which it may not tax directly." J.A. 41. These principles, the court reasoned, led inexorably to the conclusion that California's disallowance of Beatrice's interest expense

¹² As stipulated by the parties, Beatrice had exhausted all necessary administrative remedies before the Board and the California State Board of Equalization ("SBE") prior to instituting this challenge in court. Stip. ¶ 24 (J.A. 23). Because the SBE lacked jurisdiction to determine the constitutionality of provisions of the California Revenue and Taxation Code, Beatrice and the Board stipulated in August 1995 that Beatrice's administrative appeal would be dismissed without prejudice. Stip. ¶ 24 (J.A. 23).

¹³ Beatrice additionally argued at trial and on appeal that the interest offset provision violated the Equal Protection Clause of the Fourteenth Amendment, but is not pressing that claim here.

deduction violated the Due Process Clause because "[i]t disallows interest deductions on a dollar-for-dollar basis with non-taxable dividend income without regard to whether or not such interest is *related* to the dividend income." J.A. 45 (emphasis in original).

The court recognized that California might constitutionally deny an interest expense deduction that was related to income that California could not tax. J.A. 44-45. But "such potential legitimate state purpose" (J.A. 45) simply had no application to this case because

here the parties have stipulated that no portion of the proceeds of the loans generating the interest expense deductions herein went to any non-unitary corporation, each of which was responsible for its own borrowings. (J.S. ¶ 9). Thus, it appears that no portion of the interest expense deduction can be attributable to the generation of the . . . exempt dividends.

J.A. 45.

The court likewise found that the interest offset provision violated the Commerce Clause. Because only domiciliary corporations received any tax benefit from the offset of interest expense against nonunitary dividends, the court observed that it will always be true that "the amount of tax on a foreign corporation under Rev. & T.C. § 24344(b) will be higher than that of a domestic corporation where both have a) the same taxable business income; b) the same interest expense deductions; and c) the same dividend income." J.A. 48. This discrimination against foreign corporations, the court concluded, could not be squared with this Court's precedents barring discrimination against out-of-state corporations. J.A.

47-49 (citing, among other cases, *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996); *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997); and *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984)). Moreover, the differential treatment of in-state and out-of-state corporations could not be justified by any purported relationship of the interest expense to the nonunitary dividends, since there was no support in the record for the existence of such a relationship. J.A. 45-46.

(b) The Court of Appeal. In December 1998, the Court of Appeal reversed the decision of the Superior Court. The Court of Appeal conceded that, "[i]f we were writing on a clean slate," petitioner's arguments "might appear persuasive." J.A. 61. Nevertheless, the Court of Appeal believed it was bound by a 1972 decision of the California Supreme Court, *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 7 Cal. 3d 544, 498 P.2d 1030 (1972) ("*Pacific Telephone*"), which upheld the Board's statutory interpretation of the interest offset provision (Cal. Rev. & Tax. Code § 24344), even though the Court of Appeal admitted that "the *Pacific Telephone* case did not involve a constitutional challenge to section 24344." J.A. 61.

In rejecting petitioner's contention that the disallowance of an interest deduction based on the receipt of nontaxable dividends effectively taxed such dividends in violation of the Due Process Clause, the Court of Appeal felt constrained by the determination of the California Supreme Court in *Pacific Telephone* that the "inclusion of nontaxable dividends in the statutory offset computation under section 24344 does not constitute taxation of the dividends themselves." J.A. 61. Rather than defending this position, the court below simply declared that "[w]e

defer, as we must, to that decision," even though *Pacific Telephone* was not based on constitutional considerations. J.A. 61.

In dismissing petitioner's Commerce Clause argument, the Court of Appeal again relied principally on "our Supreme Court's holding in *Pacific Telephone* that the interest offset provision does not constitute a tax on the dividends in question." J.A. 62. Hence, Commerce Clause restraints applicable to taxes were not relevant because "our high court has held the interest offset provision is not a tax on the income in question here." J.A. 65. The court found this Court's decision in *Fulton* distinguishable, even though it struck down a statute like California's which conferred a tax benefit based on the extent of a taxpayer's in-state presence, on the ground that here the "alleged favorable effect on local commerce is indirect and incidental." J.A. 62. As for the long line of cases from this Court holding facially discriminatory taxes violative of the Commerce Clause, the Court of Appeal found them "not determinative" because "[i]n the absence of a directly applicable ruling by the federal Supreme Court holding unconstitutional an interest offset provision such as the one in issue here, we remain bound by *Pacific Telephone*." J.A. 63.

(c) The California Supreme Court. On March 24, 1999, the California Supreme Court denied Hunt-Wesson's petition for review. J.A. 67.



SUMMARY OF ARGUMENT

California's attempt through its interest offset provision to limit a nondomiciliary corporation's right to an otherwise available deduction for interest expense suffers from three fundamental constitutional flaws.

First, by denying a nondomiciliary corporation an interest expense deduction merely because it receives income that the Constitution forbids California from taxing, California effectively is taxing that income in violation of the Constitution. A State may not tax indirectly income that it may not tax directly. Yet that is the inescapable effect of the interest offset provision. By reducing an otherwise allowable interest expense deduction on a dollar-for-dollar basis by the amount of the dividend income it may not constitutionally tax, California increases a nondomiciliary corporation's tax base by the exact amount of that nontaxable income. Because the statute does not require – and the facts do not reveal – any relationship between the disallowed interest expense and the nontaxable income, the effect is simply to tax the exempt income, or, what amounts to the same thing, to subject one to greater burdens upon taxable income solely because one receives income that is tax-exempt. *National Life Ins. Co. v. United States*, 277 U.S. 508 (1928).

Second, by denying nondomiciliary (but not domiciliary) corporations the right to reduce their taxable income by interest expense deductions to the extent that the corporation receives dividends from nonunitary corporations, the interest offset provision discriminates against corporations domiciled outside the State. The preferential treatment persists regardless of whether the interest

expense bears any relationship to the production of the dividends in question. Because the allowance or disallowance of the deduction turns entirely on the domicile of the dividend-receiving corporation, it violates the cardinal principle of this Court's Commerce Clause jurisprudence barring taxes that facially discriminate in favor of in-state over out-of-state entities. *See, e.g., South Cent. Bell Tel. Co. v. Alabama*, 526 U.S. 160 (1999) (striking down franchise tax that favored domestic over foreign corporations).

Third, wholly apart from the question whether California may constitutionally deny an interest expense deduction, on a dollar-for-dollar basis, to the extent of a nondomiciliary taxpayer's nonunitary dividends, the interest offset provision is invalid for another, independent reason: It permits taxpayers receiving nonbusiness dividends to deduct their interest expense, but *only* to the extent that the dividends derive from corporations that are taxable in California. By conditioning a tax benefit (the deductibility of interest expense) on the extent of a corporation's in-state activity, the provision discriminates on its face against interstate commerce. In this respect, the interest offset provision is virtually identical to the North Carolina taxing scheme this Court struck down in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), where the State's intangible property tax exemption was measured by the extent of the corporation's in-state activity.

ARGUMENT

I. BY DENYING A DEDUCTION IN THE AMOUNT OF INCOME THAT CALIFORNIA IS PRECLUDED FROM TAXING UNDER THE COMMERCE AND DUE PROCESS CLAUSES, CALIFORNIA IS INDIRECTLY TAXING INCOME BEYOND ITS CONSTITUTIONAL REACH

It is "a just and well-settled doctrine established by this court, that a State cannot do that indirectly which she is forbidden by the constitution to do directly." *Passenger Cases*, 48 U.S. 283, 458 (1848) (plurality opinion). The Court has consistently applied this "great principle" (*id.* at 459) to invalidate state exactions that purport to tax indirectly what the Constitution forbids States from taxing directly. *See, e.g., id.* (striking down an exaction on foreign passengers as a prohibited "duty on tonnage," U.S. Const. art. I, § 10, cl. 3); *Guy v. Baltimore*, 100 U.S. 434, 443 (1880) (striking down wharfage fee on vessels carrying out-of-state products "as a mere expedient or device to accomplish, by indirection, what the State could not accomplish by a direct tax"); *Frick v. Pennsylvania*, 268 U.S. 473, 495 (1925) (striking down state estate tax on the ground that "[i]t would open the way for easily doing indirectly what is forbidden to be done directly, and would render important constitutional limitations of no avail"); *Lee v. Osceola & Little River Rd. Improvement Dist. No. 1*, 268 U.S. 643 (1925) (striking down state tax scheme that would "accomplish indirectly the collection of a tax against the United States which could not be directly imposed").

The practical effect of California's interest offset provision is to tax indirectly income that California has no

power, under the Commerce and Due Process Clauses, to tax directly. This conclusion follows inexorably from two undisputed propositions.

First, the dividends that petitioner received from its nonunitary subsidiaries are not constitutionally taxable by California. The law is settled that the Commerce and Due Process Clauses bar a State from taxing dividends that a nondomiciliary corporation receives from its nonunitary subsidiaries. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992); *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F.W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354 (1982). The parties accordingly have stipulated that the "dividends received by Beatrice constituted nonunitary, nonbusiness income not subject to apportionment, or taxation, by the State of California." Stip. ¶ 8 (J.A. 19).

Second, the only reason why the Board disallowed Beatrice's interest expense is because petitioner received such constitutionally exempt income. Under the interest offset provision, the relationship, if any, of the disallowed interest expense to the production of the constitutionally exempt income is simply irrelevant. Accordingly, the parties again stipulated that "[t]he disallowance of Beatrice's interest expense was due *entirely* to the receipt by Beatrice of dividends from its nonunitary subsidiaries" Stip. ¶ 14 (J.A. 21) (emphasis supplied).

By denying petitioner a deduction for interest expense equal to the amount of its constitutionally exempt income, California increases petitioner's taxable income base by the precise amount of such income. Because California denies this deduction for no reason

other than petitioner's receipt of the exempt income, the conclusion is inescapable that California effectively taxes such income. This is particularly evident when, as in this case, none of that interest expense bore any direct relationship to the production of the exempt income.¹⁴

In short, it is plain that the increase in petitioner's taxable income is attributable "entirely" (Stip. ¶ 14 (J.A. 21)) to the receipt of income that California has no power to tax under the Commerce and Due Process Clauses. Because petitioner's California tax liability was the same as if its immune income was taxable, the practical effect of the interest offset provision is to tax petitioner's constitutionally exempt income.¹⁵

The court below did not – and could not – dispute the proposition that the practical effect of the interest offset provision was to tax petitioner's exempt income.¹⁶ Instead, tracking the reasoning of the California Supreme Court opinion in *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*,

¹⁴ As the trial court observed, "it appears that no portion of the interest expense deduction can be attributable to the generation of the . . . exempt dividends." J.A. 46.

¹⁵ For example, in 1982, because Beatrice received nonbusiness dividends that California could not tax of \$19,022,617, California applied the interest offset provision and increased Beatrice's taxable income subject to apportionment by that same amount. Thus, for each dollar of immune dividend income received by Beatrice, the interest offset provision increased Beatrice's taxable income subject to California apportionment by that same dollar.

¹⁶ In fact, the Court of Appeal acknowledged the "persuasive force" (J.A. 61) of petitioner's contention that "the interest offset is overbroad, because it *fails* to apportion interest expense" (J.A. 61 (emphasis supplied)).

7 Cal. 3d 544, 498 P.2d 1020 (1972), the Court of Appeal, in substance, viewed the essential question in this case as whether the *legal* effect of the interest offset provision was the same as its *practical* effect. It held that the answer to this question is no. According to the court, the legal effect of denying a deduction was different from its practical effect on the ground that "the California Supreme Court explicitly held that inclusion of nontaxable dividends in the statutory offset computation under section 24344 does not constitute taxation of the dividends themselves." J.A. 61. Such elevation of form over substance, however, has no place in the analysis of Commerce and Due Process Clause restraints on state taxation.¹⁷

This Court has condemned, in general, efforts like California's to evade constitutional restrictions on the State's taxing power by circuitous means. It also has condemned specifically, in a related context, the precise mechanism that California seeks to employ here to tax the exempt income. In *National Life Ins. Co. v. United States*, 277 U.S. 508 (1928), this Court struck down a provision of the federal income tax law which permitted insurance

¹⁷ The Court has made it clear in analyzing constitutional restraints on State taxes that its decisions "consider [] not the formal language of the tax statute but rather its practical effect," *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977); that they evaluate "state taxation based upon its actual effect rather than its legal terminology," *American Trucking Ass'n v. Scheiner*, 483 U.S. 266, 295 (1987); that they are grounded in "economic realities," *id.*; and that they eschew "magic words or labels," *Railway Express Agency, Inc. v. Virginia*, 358 U.S. 434, 441 (1959), "avoid formalism," *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 373 (1991), and reflect "pragmatism." *Quill Corp. v. North Dakota*, 504 U.S. 298, 310 (1992).

companies to exclude municipal bond interest from their gross income but at the same time required the insurance companies to reduce an unrelated deduction for reserves by the full amount of the exempt interest. In other words, for each dollar of tax-exempt income the taxpayer received, it had to reduce an otherwise allowable deduction by one dollar. Treating the disallowance of the deduction for what it was – a transparent effort to tax exempt income by denying an unrelated deduction in the same amount – the Court ruled that “[o]ne may not be subjected to greater burdens upon his taxable property solely because he owns some that is free.” *Id.* at 519.

The statutory provision invalidated in *National Life* is remarkably similar to the California provision at issue here. In each case, a taxpayer ordinarily is entitled to claim a deduction that reduces its income tax base; in each case the taxpayer is required to forgo the deduction, and thereby increase its taxable income, by the amount of its exempt income; and in each case, the deduction need not – and does not – bear any relationship to the exempt income in question. Consequently, the Court of Appeal’s decision sustaining California’s interest offset provision cannot be squared with the rationale of *National Life* – that one may not be subjected to greater burdens upon taxable income solely because one receives income that is tax-exempt.

In short, California’s interest offset provision is a paradigmatic example of a State’s effort to tax indirectly what it may not tax directly. By reducing an otherwise allowable interest expense deduction by the amount of dividend income it may not tax under the Commerce and

Due Process Clauses, California increases a nondomiciliary corporation’s tax base by the exact amount of the exempt income. Because the statute does not require – and the facts do not reveal – any relationship between the disallowed interest expense and the nontaxable income, the effect is simply to tax the exempt income in violation of the Commerce and Due Process Clauses.

A. The Interest Offset Provision Cannot Be Defended as an Effort to Allocate Interest Expense to Related Income

Throughout this litigation, respondent’s principal defense of the interest offset provision has been that it serves to allocate interest expense to related income, *i.e.*, to the income produced by the loans on which the interest was paid. *See, e.g.*, Brief in Opposition to Petition for Writ of Certiorari (“Br. Opp.”), *passim*. If respondent’s view of the interest offset provision were accurate, petitioner would not be here. Petitioner takes no issue with the widely accepted principle that interest expense should be allocated to the income that it helps produce. But respondent’s characterization of the interest offset rule as a method for “correlating” (*id.* at 11) or “matching” (*id.* at i) or reflecting the “economic relationship between” (*id.* at 14) interest expense and related income is demonstrably false. Once the false predicate underlying respondent’s argument is removed, the defense collapses.

First, the statute itself unequivocally requires that net business interest expense must be reduced, not just by the

interest expense fairly attributable to the taxpayer's nontaxable interest and dividends, but by the full amount of those nontaxable interest and dividends.¹⁸ This reduction of the interest expense deduction by the amount of the nonbusiness interest and dividend income is absolute and unconditional.¹⁹ There is no "matching," no "correlation," no "economic relationship," no anything; just an arbitrary assignment, on a dollar-for-dollar basis, of business interest expense to nontaxable, nonbusiness income.²⁰

Second, the premise that the interest offset is merely "matching" nonbusiness income with related interest

¹⁸ As we have noted above (*see supra* p. 8), the statute permits a taxpayer a deduction for its business interest expense in the amount of its "interest income subject to allocation by formula," Cal. Rev. & Tax. Code § 24344(b), i.e., apportionable or business interest income. Hence, it is the "net" business interest expense – the interest expense attributable to business income that remains after subtracting apportionable interest income – that is at issue here.

¹⁹ The statute limits the net business interest expense deduction to the "amount, if any, by which the balance of interest expense exceeds interest and dividend income . . . not subject to allocation by formula." Cal. Rev. & Tax. Code § 24344(b).

²⁰ As noted above, even the Court of Appeal acknowledged the "persuasive force" (J.A. 61) of petitioner's contention that "the interest offset is overbroad, because it *fails* to apportion interest expense" (J.A. 61 (emphasis supplied)), but felt bound to follow the spurious position of the California Supreme Court in *Pacific Telephone*, which did not even address the federal constitutional issues raised by petitioner here, that the "inclusion of nontaxable dividends in the statutory offset computation . . . does not constitute taxation of the dividends themselves."

expense is further undermined by the fact that, under California law, nonbusiness interest expense has already been disallowed as a deduction, and thereby eliminated from the calculus, prior to the application of the interest offset provision. Stip. ¶ 11 (J.A. 20). It is only the remaining *business* interest expense that is subject to the interest offset rule, as the parties have stipulated. Stip. ¶¶ 11, 13 (J.A. 20). Accordingly, rather than "matching" interest expense to nonbusiness dividends, the interest offset rule *overallocates* such interest expense to such dividends by assigning business interest expense dollar-for-dollar to nonbusiness dividends.

Finally, respondent's attempt to justify the interest offset provision on the ground that "money . . . is fungible" (Br. Opp. at 12) and that "interest costs cannot be readily traced to the specific classification of income which is generated from both business and nonbusiness activities" (*id.*) is a classic nonsequitur. Even if money is fungible, it does not follow that California may adopt any provision – no matter how arbitrary – to allocate interest expense between taxable and nontaxable income. In fact, the interest offset provision does not even rise to the level of an arbitrary allocation provision, because, rather than allocating interest expense between taxable and nontaxable income, it simply assigns it, on a dollar-for-dollar basis, to nontaxable income.

Most tellingly of all, respondent's claim that it is "difficult" as a practical matter to determine "the extent to which interest expense is attributable to business income as opposed to nonbusiness income" (*id.*) is belied by California's own statutes and regulations requiring just such an allocation; by statutes and regulations in

other States providing for such an allocation and, in many instances, prescribing methods of fairly attributing interest expense to different classes of income even when the expenses are not traceable to a particular item or items of income; and, by the U.S. Treasury's adoption of similar interest allocation provisions for federal income tax purposes. We briefly describe these interest allocation provisions below.

1. California Itself Has Adopted Statutory and Regulatory Provisions That Seek to Allocate Interest Expense to Related Income in a Fair Manner

Despite the Board's remonstrations about the difficulty of fairly allocating interest expense to related income in light of the fungibility of money, and its invocation of those difficulties as a justification for the interest offset provision's blanket assignment of *all* business interest expense (in excess of business interest income) to nonbusiness income (Br. Opp. 12), California's statutes and regulations in fact provide for precisely the type of reasonable allocation of interest and other expenses to related income that would obviate the constitutional issues raised by this case. For example, section 24425 of the Cal. Rev. & Tax. Code precludes a deduction for "[a]ny amount otherwise allowable as a deduction which is allocable to . . . income not included in the measure of the tax." The California State Board of Equalization ("SBE") has interpreted that provision as incorporating direct tracing. Thus, if the proceeds of a loan can be directly traced to a specific business or non-business purpose, the interest expense is assigned accordingly. *See*

Appeal of Zenith Nat'l Ins. Corp., 1998 Cal. Tax LEXIS 1, 4 Cal. St. Tax Rep. (CCH) ¶ 402-965 (SBE Jan. 8, 1998), *modified*, 1998 Cal. Tax LEXIS 651, 4 Cal. St. Tax Rep. (CCH) ¶ 403-048 (SBE June 25, 1998) (a copy of these decisions are reproduced in the Appendix at App. 23a).

Moreover, even when interest expense cannot be specifically identified with any particular class of income, California has shown itself quite capable of devising reasonable methods for fairly allocating interest expense between various classes of income rather than arbitrarily offsetting such expense on a dollar-for-dollar basis against nontaxable income. Thus, the SBE has upheld the Board's denial of interest expenses allocated to nontaxable income using the ratio of nontaxable income to taxable income. *Appeal of Zenith Nat'l Ins. Corp.*, *supra*.²¹

²¹ Similarly, under subsection (c) of section 24344 (enacted after the years in issue), the California regulations attributing interest expense to foreign investment recognize that, in some circumstances, interest expense may be "related solely to specific property." Cal. Code Regs. tit. 18, § 24344(c)(4)(A). In other circumstances, where "it is difficult if not impossible to specifically assign the cost of funds to specific activities," Cal. Code Regs. tit. 18, § 24344(c)(1), California allocates the otherwise unassigned interest expense according to "the ratio of the value of foreign investment to the total value of all assets" Cal. Code Regs. tit. 18, § 24344(c)(5)(B)(i). The regulations further provide the following example of the allocation methodology with respect to interest expense that is not related to specific property or activities:

Corporation A has total interest expense of \$1,100. Specifically assigned interest expense is \$100. A has foreign investments valued at \$500 and total assets valued at \$5,500. Specifically assigned interest expense relates to total assets of \$500, none of which is foreign investment. . . .

Thus, it is plain that California does not always throw up its institutional hands – as it does in the interest offset provision – and arbitrarily assign the interest expense on a dollar-for-dollar basis to exempt income.

2. Other States Have Adopted Statutory and Regulatory Provisions That Seek to Allocate Interest Expense to Related Income in a Fair Manner

As revealed in more detail in the Appendix to this brief, most States with an income tax have adopted statutes or regulations providing for a fair allocation of interest expense to related income; many have prescribed methods of fairly attributing interest expense to different classes of income when the expenses are not clearly related to a particular item or class of income; and none has embraced a “methodology” like California’s, which simply assigns interest expense, on a dollar-for-dollar basis, to nontaxable income.²² For example:

The amount of unassigned interest expense attributable to foreign investment is calculated as follows: Total Interest Expense – Assigned Interest Expense = Unassigned Interest Expense (\$1,100 – \$100 = \$1,000). Unassigned Interest Expense x value foreign investment / value total assets (Assets without specifically assigned interest) = interest expense assignable to foreign (\$1,000 x \$500 / \$5,000 = \$100).

Cal. Code Regs. tit. 18, § 24344(c)(5)(B)(iii).

²² While there may be interpretations or administrative practices not apparent on the face of the state statutes and regulations that we reviewed, our research disclosed only two States (Idaho and Wisconsin) that ever had an interest offset

- Alabama prorates interest expense deductions between business and nonbusiness income by multiplying total interest expense by the ratio of the average cost of nonbusiness assets to the average cost of total assets;²³
- the District of Columbia reduces a corporation’s deductible interest expense according to the ratio of the average value of the assets producing nontaxable income to the average value of the corporation’s total assets;²⁴
- Hawaii provides for the proration of deductions among items of business and nonbusiness income in a manner that fairly distributes the deduction among the classes of income to which it is applicable, and, when deductions are not connected with particular classes of income, it provides for an allocation based on the ratio of Hawaii gross income to gross income from all sources;²⁵
- Kentucky provides that deductions allowed under the Internal Revenue Code be reduced by expenses allocable to nontaxable income, and it prescribes a number of methods for allocating interest and other expenses to nontaxable income (including asset- and income-based ratios);²⁶
- Louisiana, Mississippi, Nebraska, New York, North Carolina, Oklahoma, and Utah have

provision anything like California’s, and neither of those States has such a provision in effect today.

²³ Ala. Code § 40-18-35(a)(2). See App. 1a.

²⁴ D.C. Reg. § 123.4. See App. 4a.

²⁵ Hawaii Reg. § 18-235-5-03(b)(4). See App. 6a.

²⁶ Ky. Rev. Stat. Ann. § 141.010(13)(d); Ky. Admin. Release, Revenue Policy 41P150 (June 1, 1983). See App. 9a.

adopted similar mechanisms for allocating interest expense between taxable and nontaxable income, when the interest income cannot readily be traced to any particular item or activity;²⁷ and

- Other States (including Alaska, Arizona, Colorado, Kansas, Missouri, North Dakota, and Oregon) have adopted the Multistate Tax Commission regulations which provide for the proration of deductions among items of business and nonbusiness income in a manner that fairly distributes the deduction among the classes of income to which it is applicable.²⁸

The States' widespread adoption of a variety of methods, reasonable on their face, for attributing interest expense to the income it produces, even in circumstances when the expenses cannot be traced directly to particular classes of income, underscores the anomalous character of California's interest offset rule, as well as its indefensibility.

3. The Federal Government Likewise Has Adopted Rules That Seek to Allocate Interest Expense to Related Income in a Fair Manner

The Federal Government's adoption of provisions for allocating interest expense to related income, which are analogous to the provisions adopted by many of the

²⁷ See App. *passim*.

²⁸ See App. *passim*.

States, reinforces the conclusion that California has available to it a wide variety of reasonable alternatives to the interest offset provision for matching interest expense to interest income. For example, Section 265 of the Internal Revenue Code disallows a deduction for interest on indebtedness incurred to "purchase or carry" tax-exempt obligations. I.R.C. § 265. In prescribing the methods for allocating interest expense to the exempt obligations, the Internal Revenue Service will disallow any interest that is "directly traceable" to the holding of tax-exempt obligations and, where interest cannot be so traced:

[t]he amount of interest on such indebtedness to be disallowed shall be determined by multiplying the total interest on such indebtedness by a fraction, the numerator of which is the average amount during the taxable year of the taxpayer's tax-exempt obligations . . . and the denominator of which is the average amount during the taxable year of the taxpayer's total assets

Rev. Proc. 72-18, 1972-1 C.B. 740; see also Treas. Reg. § 1.265-1(c).²⁹

Similarly, in determining the appropriate allocation of interest expense to domestic and foreign source income, the federal income tax regulations provide for the apportionment of interest expense to various income-producing activities by an asset ratio and by a gross income ratio. Treas. Reg. § 1.861-9T. These regulations proceed on the premise that "money is fungible and that

²⁹ California itself has adopted this methodology under Section 24425. See, e.g., *Appeal of Zenith Nat'l Ins. Co.*, *supra*.

interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid." Treas. Reg. § 1.861-9T(a). Ironically, respondent relied on these regulations in the proceedings below, defending the interest offset provision as reflecting the same "recognition of the fungible nature of money" as underlies the regulations. Defendant's Franchise Tax Board's Trial Brief (CT p. 178). What respondent utterly failed to appreciate, however, is that the very regulations on which it relied provide for a rational asset-based or income-based allocation of interest to various classes of income, Treas. Reg. §§ 1.861-9T(g), (j), not the wholesale assignment of interest expense to exempt income embodied in the interest offset provision.

* * *

In sum, California's interest offset provision is a deeply flawed and virtually unique approach to the problem of allocating interest expense to related income. It offends bedrock constitutional norms – not to mention common sense – by sweeping nonunitary dividends into the tax base under the guise of denying a deduction, on a dollar-for-dollar basis, for interest expense without regard to the relationship of the interest expense to the interest income. The claim that this anomalous provision is somehow justified because "money, by its very nature, is fungible" (Br. Opp. 12) does not survive scrutiny. The widespread adoption by other States, by the Federal Government, and by California itself of methods designed to allocate fairly interest expense to related income, even in circumstances when the expense cannot be traced to particular income-producing activity, demonstrates that

there are reasonable, and presumptively constitutional, alternatives to the interest offset provision.

II. BY PROVIDING LESS FAVORABLE INTEREST EXPENSE DEDUCTIONS FOR NONDOMICILIARY CORPORATIONS THAN FOR DOMICILIARY CORPORATIONS, CALIFORNIA'S INTEREST OFFSET RULE DISCRIMINATES AGAINST INTERSTATE COMMERCE

At the same time that the interest offset provision permits California to tax nonunitary income that lies beyond its constitutional reach, it creates a second constitutional difficulty of equal concern: It discriminates against nondomiciliary corporations in favor of domiciliary corporations.

To appreciate the nature of this discrimination, one must first understand how California taxes nonbusiness dividends earned by domiciliary and nondomiciliary corporations. Under California's rules for allocation of nonbusiness income, "dividends are allocable to this state if the taxpayer's commercial domicile is in this state." Cal. Rev. & Tax. Code § 25126. Consequently, all of a domiciliary's nonbusiness dividends are allocable to – and taxable by – California. By the same token, none of a nondomiciliary's nonbusiness dividends are allocable to – or taxable by – any State in which it is not domiciled. See Stip. ¶ 8 (J.A. 19).

As discussed above, the interest offset provision requires taxpayers to offset their net business interest expense by the amount of their nonunitary, nonbusiness dividends. For a nondomiciliary taxpayer like petitioner,

this requirement deprives it of the benefit of an interest expense deduction for California tax purposes. It does so by arbitrarily assigning the interest expense to nonbusiness dividends – income that, as we have just explained, California does not tax when earned by nondomiciliaries. See Cal. Rev. & Tax. Code §§ 25123, 25126. The provision thereby reduces the nondomiciliary's *nontaxable* income and leaves its California taxable income intact.

But the opposite is true for a domiciliary corporation, which enjoys the full benefit of an interest expense deduction for California tax purposes. By assigning the domiciliary corporation's net business interest expense to nonbusiness income – income that California fully taxes when earned by domiciliaries, see Cal. Rev. & Tax. Code §§ 25123, 25126 – the interest offset provision reduces the domiciliary taxpayer's *taxable* California income.

At first blush, one might view this claim of discrimination as nothing more than a description of the natural consequences of allowing an interest expense deduction that corresponds to the State's power to tax nondomiciliary and domiciliary taxpayers' income. Since California has no power to tax any of the nondomiciliary taxpayer's nonbusiness dividends, California's disallowance of the expense deduction corresponds simply to its lack of power to tax the dividends, not to the taxpayer's nondomiciliary status. By the same token, since California has the power to tax all the domiciliary taxpayer's nonbusiness dividends, California's allowance of the interest expense deduction corresponds simply to its power to tax the dividends, not to the taxpayer's domiciliary status.

The critical flaw in this analysis, however, is that it is based on the false premise that there is some relationship between the nonbusiness dividend income and the expenses that are being assigned to it. If there is no relationship between the nonbusiness dividends and the interest expenses, then the denial or grant of a deduction for the interest expenses cannot be justified by reference to the State's power to tax the nonbusiness dividends. Rather, the denial or grant depends solely on the taxpayer's domicile.

Consider, for example, two corporations D and ND, identical in every respect except that D is a domiciliary of California and ND is a nondomiciliary. Assume both corporations manufacture and sell widgets in California and in other States. Each has \$1,000 of apportionable business income from its widget operations, \$200 of interest expense on a loan whose proceeds were used to purchase widget manufacturing machinery, and \$200 of dividends from a nonunitary subsidiary producing Hula Hoops in Outer Mongolia. Under the interest offset provision, D will be able to deduct the full \$200 of interest expense from its California tax base, but ND will be able to deduct nothing. Because the interest offset provision in effect transforms business interest expense into nonbusiness interest expense, it permits D to enjoy (albeit under false pretenses) a deduction against its otherwise taxable nonbusiness dividend while providing ND with a meaningless deduction against the nonbusiness dividend that California cannot tax anyway. Because it is irrelevant under the interest offset provision whether the disallowed interest expense bears any relationship to the production of the income against which the expense is offset, it is apparent that the allowance or disallowance of the

deduction turns entirely on the domicile of the dividend-receiving corporation.³⁰

California's discrimination against nondomiciliary corporations in favor of domiciliary corporations patently violates established Commerce Clause criteria. The rule prohibiting taxes that discriminate against interstate commerce has been a central tenet of this Court's Commerce Clause doctrine from the very beginning. *See, e.g., Welton v. Missouri*, 91 U.S. 275 (1876); *Cook v. Pennsylvania*, 97 U.S. 566 (1878). No aspect of this doctrine is more firmly entrenched than the principle that a State may not favor in-state over out-of-state entities. *See, e.g., Robbins v. Shelby County Taxing Dist.*, 120 U.S. 489 (1887); *Nippert v. City of Richmond*, 327 U.S. 416 (1946). This Court has repeatedly condemned taxes that "favor[] domestic corporations over their foreign competitors." *Fulton Corp. v. Faulkner*, 516 U.S. 325, 333 (1996).

Just last Term, the Court applied these principles in striking down Alabama's franchise tax in *South Cent. Bell Tel. Co. v. Alabama*, 119 S. Ct. 1180 (1999). Alabama's

³⁰ Even the California Supreme Court has acknowledged that the interest offset provision affords a more favorable interest expense deduction to California domiciliaries than to those domiciled elsewhere. Table II and Table IV and the related discussion in the *Pacific Telephone* decision show that two identical corporations, except one is domiciled in California and one is domiciled outside California, are granted different interest expense deductions in California. 7 Cal. 3d at 551, 553. Under the interest offset, the California corporation is allowed a full \$2 interest expense deduction, *id.* at 551 (Table II), whereas the non-California corporation is allowed no deduction for any of its interest expense. *Id.* at 553 (Table IV).

taxing scheme favored domestic over foreign corporations by giving domestic – but not foreign – corporations the ability to reduce their franchise tax liability by reducing the par value of their stock. *Id.* at 1185-86. Observing that the tax "facially discriminates against interstate commerce," a unanimous Court invalidated the tax in short order.

California's preference for its own domiciliary corporations is no different in substance from Alabama's domestic preference legislation condemned in *South Central Bell*. As in *South Central Bell*, there can be no dispute that the taxing scheme in question treats local corporations more favorably than their out-of-state competitors.³¹ When domiciliary corporations receive dividends from nonunitary corporations, they receive the full benefit of an interest expense deduction against taxable income. Nondomiciliary corporations, by contrast, must forgo the benefit of the interest expense deduction to the extent of their nonunitary dividends. The preferential treatment persists regardless of whether the interest expense bears any relationship to the production of the dividends in question. Since the allowance or disallowance of the deduction turns entirely on the domicile of the dividend-receiving corporation, it violates the "virtually *per se* rule of invalidity" that this Court applies to facially discriminatory taxes. *See, e.g., Camps Newfound/Owatonna Inc. v. Town of Harrison*, 520 U.S. 564, 596 (1997).

³¹ Indeed, respondent has acknowledged that the interest offset provision operates to "increase taxes on foreign corporations while reducing those of domestic corporations." *Pacific Telephone*, 7 Cal. 3d at 554.

III. CALIFORNIA'S DENIAL OF A DEDUCTION TO THE EXTENT THAT A TAXPAYER'S SUBSIDIARY "PARTICIPATES IN INTERSTATE COMMERCE" IS INDISTINGUISHABLE FROM THE STATE TAXING SCHEME CONDEMNED IN *FULTON CORP. V. FAULKNER*, 516 U.S. 325, 333 (1996), AND PROVIDES A WHOLLY INDEPENDENT BASIS FOR INVALIDATING THE INTEREST OFFSET PROVISION

Even if this Court were to find that California is constitutionally entitled to deny petitioner an interest expense deduction to the extent of its nonunitary dividends, the interest offset provision still fails to satisfy constitutional strictures for another, wholly independent, reason: It permits nondomiciliary taxpayers receiving nonbusiness dividends to deduct their interest expense, but *only* to the extent that the dividends derive from corporations that are taxable in California. The interest offset provision therefore offends the Commerce Clause principle that state taxing schemes may not favor in-state over out-of-state investment, *see, e.g., Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388 (1984); *Maryland v. Louisiana*, 451 U.S. 725 (1981), and is virtually indistinguishable from the North Carolina tax regime the Court invalidated in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).

Under the interest offset provision, a taxpayer must reduce its otherwise deductible interest expense by dividends received from nonunitary corporations "except dividends deductible under the provisions of Section 24402." Cal. Rev. & Tax. Code § 24344(b). Dividends deductible under Cal. Rev. & Tax. Code § 24402 are dividends "declared from income which has been included in

the measure of" California's franchise tax. Accordingly, the exception to the required reduction of deductible interest expense – and the consequent increase in California taxable income – is correlated to the proportion of the taxpayer's dividend-paying subsidiaries' business that is conducted in California. This Court struck down a strikingly similar taxing scheme in *Fulton*.

In *Fulton*, the Court considered a North Carolina intangible property tax as applied to taxpayers who owned corporate stock. The tax was imposed at the rate of 0.25 percent of the fair market value of the stock. The value of the stock assessed under the tax, however, was reduced by a percentage equal to the percentage of the corporation's income subject to tax in North Carolina. Under this regime, if the stock was issued by a corporation doing all of its business in North Carolina, a 100 percent reduction of the value of the stock would be allowed; if the stock was issued by a corporation doing 50 percent of its business in North Carolina, a 50 percent reduction of the value of the stock would be allowed; and if the stock was issued by a corporation doing none of its business in North Carolina, no reduction of the value of the stock would be allowed.

The Court had no hesitation in branding North Carolina's taxing scheme as "facially" discriminatory (*id.* at 333):

A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at

least, to discourage domestic corporations from plying their trades in interstate commerce.

Id.

California's interest offset scheme suffers from precisely the same constitutional infirmity. It permits a non-domiciliary taxpayer an interest deduction against taxable income (and thus a reduction in California tax) only to the extent that a nonunitary, dividend-paying subsidiary does business in California. Thus, just as in North Carolina, the taxpayer receives a benefit only insofar as the corporation in which it has invested is doing business in the taxing State. If the taxpayer's nonunitary, dividend-paying subsidiary were doing all of its business in California, a 100 percent deduction of the taxpayer's otherwise deductible interest expense would be allowed; if the taxpayer's nonunitary, dividend-paying subsidiary were doing 50 percent of its business in California, 50 percent of the taxpayer's otherwise deductible interest expense would be allowed; and if the taxpayer's nonunitary, dividend-paying subsidiary were doing none of its business in California, none of the taxpayer's otherwise deductible interest expense would be allowed.

The Court's conclusion with regard to the North Carolina regime applies equally to the California regime:

A regime that [denies an interest deduction] only to the degree that [the dividend-paying subsidiary] participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among [California] residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.

Fulton, 516 U.S. at 333. Accordingly, Cal. Rev. & Tax. Code § 24344(b) "facially discriminates against interstate commerce." *Id.*

Little more needs to be said after *Fulton* about the unconstitutionality of California's discrimination in favor of taxpayers who invest in corporations that conduct their activity in California rather than in other States. Nevertheless, it is plain that the provision is wholly irreconcilable with the bedrock principle of this Court's Commerce Clause jurisprudence that "a State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State." *Armco, Inc. v. Hardesty*, 467 U.S. 638, 642 (1984). California's interest offset provision fails to satisfy this criterion.

Consider the choice facing a nondomiciliary corporation like petitioner, which is taxable in California and is considering whether to invest in nonunitary Corporation A, which does business only in California, or in nonunitary Corporation B, which does business only in other States. If petitioner invests in Corporation A, it will receive a deduction for its net interest expense to the extent of the dividends paid by Corporation A. If it invests in Corporation B, it will be denied a deduction for its net interest expense to the extent of the dividends paid by Corporation B.

A more blatant violation of the Court's Commerce Clause doctrine is difficult to imagine. A nondomiciliary corporation which invests in a subsidiary engaged in activity in other States is penalized by comparison to its competitor which invests in a subsidiary that plies its

trade within the taxing State. The price of investing outside California is the loss of an interest expense deduction. California's taxing scheme therefore "forecloses tax-neutral decisions" (*Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 331 (1977)) and has a forbidden impact on interstate commerce because "it exerts an inexorable hydraulic pressure on interstate businesses to ply their trade within the State that enacted the measure rather than 'among the several States.'" *American Trucking Ass'ns v. Scheiner*, 483 U.S. 266, 286-87 (1987).³²



³² We wish to reiterate that the constitutional difficulties engendered by the limitation of the interest expense deduction to dividends received from corporations doing business in California exist entirely aside from the constitutional infirmities we have addressed in Points I and II above. *See supra* 18 and 33. Even if the general disallowance of interest expense due to the receipt of tax-exempt dividends were sustained, California still would be precluded from selectively allowing an interest expense deduction based on the extent of the in-state presence of the taxpayer's dividend-paying subsidiaries. Indeed, even if there were no interest offset provision at all, and California simply denied any deduction for interest expense, except to the extent that one received dividends from corporations paying tax in California, the limitation would fail to pass constitutional muster for the reasons set forth above. In short, the denial to petitioner of an interest expense deduction to the extent that its dividend-paying subsidiaries did not derive their income from California is fatally defective, wholly apart from the interest offset provision's other constitutional deficiencies.

CONCLUSION

For the foregoing reasons, the judgment of the California Court of Appeal should be reversed.

Respectfully submitted,

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APPENDIX**STATE-BY-STATE TREATMENT OF
INTEREST EXPENSE ALLOCATION**

STATE	STATUTE OR REGULATION	PERTINENT LANGUAGE
Alabama	Ala. Code § 40-18-35(a)(2)	"All interest paid or accrued within the taxable year on its indebtedness as determined in accordance with 26 U.S.C. Sections 163, 264, and 265. In the case of a corporation not commercially domiciled in Alabama, the amount of interest otherwise deductible under this subdivision shall be reduced by the amount that bears the same ratio to the total interest expense as the average value of the corporation's assets producing nonbusiness income bears to the average value of the corporation's total assets . . . "

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Alaska

Alaska Reg.,
15 AAC 20.620

"Expenses incurred in acquiring, maintaining, and disposing of tax-exempt assets, including interest expense, may not be deducted in computing taxable income."

Alaska Reg.,
15 AAC 19.041

" . . . the deduction shall be prorated among those trades or businesses and those items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable."

Arizona

Ariz. Rev. Stat.
§ 43-961(5)

Deduction not allowed for: "Any amount, not otherwise provided for by this section, that would otherwise be allowable as a deduction or an adjustment, which is allocable to one or more classes of income, whether or not any amount of income of that class or classes is received or accrued, and that is not required to be included in a person's Arizona adjusted gross

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income or Arizona taxable income."

Ariz. Reg., R15-
2-1131(C)

" . . . deduction shall be prorated among such trades or businesses and such items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable."

Arkansas

Ark. Code Ann.
§ 26-51-431(c)

"For the purpose of computing Arkansas corporation income tax liability, no deduction shall be allowed for:

. . .

(2) Interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by Arkansas law"

California

Cal. Rev. &
Tax. Code
§ 24344(a)

"Section 163 of the Internal Revenue Code relating to interest, shall apply, except as otherwise provided."

Cal. Rev. &
Tax. Code
§ 24344(b)

Interest offset provision.

Colorado	Colo. Reg. IV.1(d)(1)	" . . . deduction shall be prorated among such trades or businesses and such items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable."
Delaware	Del. Code, tit. 30, § 1903(b)(5)	"Interest (including discount) to the extent included in determining entire net income under subsection (a) of this section, less related or applicable expenses, shall be allocated to the state where the transaction took place which resulted in the creation of the obligation with respect to which the interest was earned."
District of Columbia	D.C. Reg., § 123.4	" . . . interest expenses of a corporation, financial institution, or unincorporated business shall be reduced by the amount that the ratio of the average value of the assets producing nontaxable income

		bears to the average value of the total assets of the corporation, financial institution or unincorporated business."
Florida	Fla. Stat. ch. 220.03(1)(r)	" . . . 'income' means gross receipts less all expenses directly or indirectly attributable thereto."
Georgia	Ga. Reg., § 560- 7-7-.03 (3)	" . . . All expense connected with earning such investment income, such as interest on money borrowed to pay for such property, . . . shall be deducted from the gross investment income. The net investment income is not subject to apportionment."
Hawaii	Haw. Rev. Stat. § 235-7(e)	"There shall be disallowed as a deduction the amount of interest paid or accrued within the taxable year on indebtedness incurred or continued, (1) to purchase or carry bonds the interest upon which is excluded from gross

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income . . . ; or (2) to purchase or carry property owned without the State, or to carry on trade or business without the State, if the taxpayer is a person taxable only upon income from sources in the State."

Hawaii Reg.
§ 18-235-
5-03(b)(4)

"Deductions from Hawaii adjusted gross income that are not connected with particular property or income, such as medical expenses, shall be allowed only to the extent of the ratio of Hawaii adjusted gross income to adjusted gross income from all sources."

Idaho

Idaho Code
§ 63-3027(d)

"In the case of allocable nonbusiness interest or dividends, related expenses include interest on indebtedness incurred or continued to purchase or carry assets on which the interest or dividends are non-business income."

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Illinois

35 Ill. Comp.
Stat. 5/303(a)

"Any item of capital gain or loss, and any item of income from rents or royalties from real or tangible personal property, interest, dividends, and patent or copyright royalties, and prizes awarded under the Illinois Lottery Law, to the extent such item constitutes nonbusiness income, together with any item of deduction directly allocable thereto, shall be allocated by any person other than a resident as provided in this Section."

Indiana

Ind. Reg.,
Rule 45
IAC 3.1-1-56

"Rents, royalties, capital gains, interest and dividends when considered nonbusiness income are allocated to specific jurisdictions as outlined in Regulations 6-3-2-2(h) through 6-3-2-2(k) [45 IAC 3.1-1-57 - 45 IAC 3.1-1-61]. Such income and the deductions connected therewith are not taken into

consideration in computing the taxpayer's apportionment formula. When the taxpayer has deductions applicable to both business and nonbusiness income, such deductions must be prorated to determine what part is subject to allocation."

Iowa

Iowa Reg., Rule
701 - 54.3(422)

" . . . Related expenses shall mean those expenses directly related, including related federal income taxes

A directly related expense shall mean an expense which can be specifically attributed to an item of income
 "

Kansas

Kan. Stat. Ann.
§ 79-3274

" . . . Allocable non-business income shall be limited to the total nonbusiness income received which is in excess of any related expenses which have been allowed as a deduction during the income year."

Kan. Reg.,
§ 92-12-74

" . . . deduction shall be prorated among such trades or businesses and such items

of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable."

Kentucky

Ky. Rev.
Stat. Ann.
§ 141.010(13)(d)

No deduction for "[a]ny deduction directly or indirectly allocable to income which is either exempt from taxation or otherwise not taxed
 "

Ky. Admin.
Release,
Revenue
Policy 41P150
(June 1, 1983)

"If actual expenses, such as interest, salaries, general and administrative and other stewardship expenses, cannot be related directly to such income, a formula must be used."

Louisiana

La. Reg.,
§ 1130(B)(1)

"The amount of interest which is applicable to such investments shall be determined by multiplying the total amount of interest expense by a ratio, the numerator of which is the average value of investments which produce or which are held for the

		production of allocable income, and the denominator of which is the average value of all assets of the taxpayer."
Maine	Me. Reg., Rule No. 801(.03)	"Any allowable deduction that is applicable both to business and nonbusiness income or to more than one trade or business of the taxpayer shall be prorated to those classes of income or trades or businesses in determining income subject to tax."
Maryland	No provision	
Massachusetts	Mass. Gen. Laws ch. 63, § 30.4	" . . . any deduction otherwise allowable which is allocable, in whole or in part, to one or more classes of income not included in a corporation's taxable net income, as determined under subsection (a) of section thirty-eight, shall not be allowed."
Michigan	No corporate income tax	

Minnesota	Minn. Stat. § 290.10	" . . . in computing the net income of a taxpayer no deduction shall in any case be allowed for expenses, interest and taxes connected with or allocable against the production or receipt of all income not included in the measure of the tax imposed by this chapter "
	Minn. Stat. § 290.17(1)(b)	"Expenses, losses, and other deductions . . . must be allocated along with the item or class of gross income to which they are definitely related for purposes of assignment Deductions not definitely related to any item or class of gross income are assigned to the taxpayer's domicile."
Mississippi	Miss. Code § 27-7-23(c)(4)(H)	"Nonbusiness interest expense shall be computed by using the ratio of nonbusiness assets to total assets applied to total interest expense."

Missouri	Mo. Reg., 12 CSR 10-2.075(6)	" . . . the deduction shall be prorated among the trades or businesses and the items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable."
Montana	Mont. Code Ann. § 15-31- 114(1)(d)	"Interest may not be allowed as a deduction if paid on an indebtedness created for the purchase, maintenance, or improvement of property or for the conduct of business unless the income from the property or business would be taxable under this part."
Nebraska	Neb. Rev. Stat. § 77-2734.06(3)	"The interest expense for the reduction required . . . shall be determined by dividing the taxpayer's average investment in the activities producing the income by the taxpayer's average total assets and multiplying such ratio by

		the total interest deduction allowed in the computation of federal taxable income."
Nevada	No corporate income tax	
New Hampshire	N.H. Rev. Stat. Ann. § 77-A:4(X)	"In the case of a business organization which excludes any portion of its gross business profits pursuant to federal constitutional law, an addition to gross business profits for the amount of any deducted expenses related to such excluded portion."
New Jersey	N.J. Rev. Stat. § 54:10A-6.1(b)	"Corporate expenses related to nonoperational income are not deductible in determining entire net income."
New Mexico	N.M. Admin. Code tit. 3 § 5.5.8	"From the items of gross income from rents, patent and copyright royalties, interest, dividends and capital gains being specifically allocated to or outside this state, there shall be deducted the

expenses related thereto. The term 'expenses related thereto' as used in this section (3 NMAC 5.5.8) means the expenses and other deductions directly attributable to such rents, patent and copyright royalties, interest, dividends and capital gains and a ratable part of any other expenses or deductions which cannot definitely be allocated to some item or class of income."

New York

N.Y. Tax Law,
Ch. 60,
§ 208.9(b)(6)

"Entire net income shall be determined without the exclusion, deduction or credit of: . . .

In the discretion of the tax commission, any amount of interest directly or indirectly . . . attributable as a carrying charge or otherwise to subsidiary capital or to income, gains or losses from subsidiary capital."

N.Y. Tax Law,
Ch. 60, § 208.6

"The term 'investment income' means the sum of (a) income, . . . less, (c) in the discretion of the commissioner, any deductions allowable in computing entire net income which are directly or indirectly attributable to investment capital or investment income"

North
Carolina

N.C.
Regulation,
Rule,
§ 17:05C.0304,
subds. b and c

" . . . shall attribute a portion of the interest expense to such untaxed income and property in determining taxable income reported to this State. The formula used for computing the amount of interest expense to be attributed to untaxed income and property is as follows"

North Dakota

N.D. Reg.,
§ 81-03-09-06

" . . . deduction shall be prorated among such trades or businesses and such items of nonbusiness income in a manner which fairly distributes the deduction among the

Ohio

Ohio Rev. Code § 5733.04(I)(2) "For purposes of determining net foreign source income deductible under division (I)(2) of this section, the amount of gross income from all such sources other than income derived by application of section 78 or 951 of the Internal Revenue Code shall be reduced by: . . .

(c) Fifteen per cent of the amount of dividends and all other income.

The amounts described in divisions (I)(2)(a) to (c) of this section are deemed to be the expenses attributable to the production of deductible foreign source income unless the taxpayer shows, by clear and convincing evidence, less actual expenses, or the tax commissioner shows,

classes of income to which it is applicable."

Oklahoma

Okla. Stat. tit. 68 § 2358(A)(4)

by clear and convincing evidence, more actual expenses."

"Allowable deductions attributable to items separately allocable . . . , whether or not such items of income were actually received, shall be allocated on the same basis as those items"

Okla. Rule 710:50-17-51(6)

"The expense adjustment is used to more clearly reflect true income. The manner in which this adjustment is made is as follows: A fraction, or percentage, is computed by dividing the average of investment in assets, the income from which is nontaxable, by the average of total assets. This result is then applied to certain expenses claimed on the return. Generally, interest expense is the only expense against which this result is applied. However, facts and circumstances may

indicate that other expenses should be considered in this allocation. This adjustment will be considered in all cases where deemed appropriate."

Oregon

Or. Admin. R.,
§ 150-314.610
(1)-(C)

" . . . deduction shall be prorated among such trades or businesses and such items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable."

Pennsylvania

72 Pa. Cons.
Stat. § 7401
(3)(b.1)

"An additional deduction shall be allowed from taxable income in the amount of any interest income from securities issued by the United States or agencies or instrumentalities thereof, to the extent included in Federal taxable income but exempt from the tax imposed by this article under the laws of the United States, but reduced by any

interest on indebtedness incurred to carry the securities, any expenses incurred in the production of such interest income and any other expenses deducted on the federal income tax return that would not have been allowed under Section 265 of the Internal Revenue Code . . . if the interest were exempt from Federal income tax."

Rhode Island No provision

South Carolina 27 S.C. Code
Reg., § 117-73

"The term 'related expenses' . . . shall mean any cost incurred, directly or indirectly, in connection with investments for the production of income or future income which is or will be specifically and directly allocable under this section or costs incurred in the acquisition, sale or exchange of real, tangible, or intangible property."

South Dakota No corporate
income tax

Tennessee	Tenn. Rule 1320-6-1-.23(3)	"In the absence of evidence to the contrary, it is assumed that the expenses related to non-business rental earnings will be an amount equal to 50% of such earnings and that expenses related to other non-business earnings will be an amount equal to 5% of such earnings."
Texas	No corporate income tax	
Utah	Utah Code Ann. § 59-7-101(19)	" 'Related expenses' means: (a) expenses directly attributable to non-business income; and (b) the portion of interest or other expense indirectly attributable to both nonbusiness and business income which bears the same ratio to the aggregate amount of such interest or other expense, determined without regard to this subsection, as the average amount of the asset

		producing the non-business income bears to the average amount of all assets of the taxpayer within the taxable year."
Vermont	No provision	
Virginia	23 VAC 10-120-20	"The federal procedure in Treasury Reg. § 1.861-8 is applied to allocate and apportion expenses to income derived from U.S. and foreign sources."
Washington	No corporate income tax	
West Virginia	W.Va. Code § 11-24-6 (b)(2)	"There shall be added to federal taxable income, unless already included in the computation of federal taxable income . . . Interest or dividends, less related expenses to the extent not deducted in determining federal taxable income"
Wisconsin	Wisc. Stat. § 71.26(3)(L)	" . . . any amount otherwise deductible under this chapter that is directly or indirectly related to income wholly exempt

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from taxes imposed by this chapter or to losses from the sale or other disposition of assets the gain from which would be exempt under this paragraph if the assets were sold or otherwise disposed of at a gain is not deductible."

Wyoming No corporate
income tax

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In the Matter of the Appeal of
Zenith National Insurance Corp.

No. 94A-0767

STATE BOARD OF EQUALIZATION OF THE
STATE OF CALIFORNIA

1998 Cal. Tax LEXIS 1; 98-SBE-001

January 8, 1998

COUNSEL:

Representing the Parties:

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Anthon S. Cannon, Jr., Attorney.

For Respondent:

Edward J. Kline, Counsel.

Counsel for Board of Equalization: Derick J. Brannan,
Tax Counsel.

OPINION BY: PER CURIAM

OPINION

This appeal is made pursuant to section 19045¹ of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Zenith National Insurance Corporation against proposed assessments of additional franchise tax in the amounts of \$50,110.24, \$199,271.49, \$207,646.62 and \$254,690.00 for the income years ended December 31, 1982, December 31, 1983, December 31, 1984, and December 31, 1985, respectively. The basic issue on appeal is whether interest expense incurred in connection with the issuance of corporate

¹ Unless otherwise specified, all section references in the text of this opinion are to sections of the Revenue and Taxation Code in effect for the income years in issue.

debentures should be allocated to taxable or nontaxable income for purposes of determining the deductibility of that expense.

During the subject income years, appellant owned all of the stock in the Zenith Insurance Company (hereafter ZIC). ZIC held a license to conduct insurance business in the State of California and was subject to the California tax on gross insurance premiums; as a result, ZIC dividends paid to appellant were not included in appellant's measure of tax pursuant to section 24410. (See Rev. & Tax. Code, Part 7, § 12001 et seq., and Part 11, § 23001 et seq.) Further, because section 24425 precludes a deduction for any expense allocable to a class of income which is not subject to the Bank and Corporation Tax, to the extent that appellant incurred expenses allocable to dividend income from ZIC, those expenses would not be deductible.

During the subject income years, appellant incurred significant interest expense in connection with the issuance of corporate debentures. Appellant used the debenture proceeds to develop a diverse portfolio of preferred stock. The preferred stock generated dividend income which was taxable pursuant to the California Bank and Corporation Tax, and on that basis, appellant deducted all of its debenture-related interest expense. On audit, respondent reallocated appellant's interest expense deductions between appellant's income from the preferred stock dividends and its income from the ZIC dividends. Respondent utilized a formula to allocate the interest expense in accordance with the ratio of appellant's insurance-related income (income excluded from the bank and corporation tax) to appellant's gross income

(all income whether excluded or not). Appellant disputes the use of this general allocation formula, and the basic issue on appeal is how properly to allocate, if at all, the debenture interest expense between appellant's taxable and nontaxable activities.

On September 9, 1982, appellant's Board of Directors generally discussed the infusion of additional capital into the company in order to enhance its stature and earnings. At a subsequent meeting, the Board of Directors approved the issuance of debentures with a face value of \$50 million; the minutes for that meeting do not contain any reference as to the specific intended use for the debenture proceeds. However, the offering brochure which accompanied the debentures indicated as follows:

"The offering will provide funds which will be available for general corporate purposes. A portion of the proceeds may be used for the repayment of [appellant's] or ZIC's bank indebtedness, aggregating \$18,500,000 at September 30, 1982, of which approximately \$3,260,000 is due in 1983. A portion of the proceeds may also be loaned or contributed to ZIC for additions to its investment portfolio or may be used by [appellant] for possible acquisitions. [Appellant] is not currently engaged in any acquisition discussions. For such purposes [appellant] may incur additional indebtedness."

In slight contrast to the general language contained in the brochure, appellant offers a number of declarations from key executives to the effect that appellant issued the debentures with the dominant purpose of investing the proceeds in preferred stock, and in turn, gaining the

federal tax advantages of the intercorporate dividend deduction.

On October 15, 1982, appellant issued debentures with a face value of \$50 million and which generated net proceeds of \$47,847,000. In November of 1982, shortly after it received the debenture proceeds, appellant paid off \$8.5 million in short term bank debt, purchased some additional short term money market investments and advanced \$15 million to ZIC; ZIC repaid those funds with interest between December 1982 and January 1983. By March 31, 1983, less than six months after it issued the debentures, appellant had amassed a portfolio of preferred stock valued at \$49.6 million.

Between September and December of 1983, appellant's board increased various lines of credit and guaranteed certain indebtedness of ZIC. Thereafter, ZIC used proceeds from a loan guaranteed by appellant in order to repay a loan from appellant; ZIC also used similar proceeds to increase its own insurance reserves. In spite of this mutually beneficial financing, appellant's president testified under oath at the hearing that the debenture proceeds were "totally separable" from appellant's other banking activities, "because there really [were] no other liquid assets in the [appellant]." Further, appellant never sold any of its preferred stock to meet ZIC's financial needs.

The preferred stock portfolio remained relatively stable in value until July of 1985. At that time, appellant successfully bid \$40 million for the CalFarm Insurance Company (hereafter CalFarm). Upon acceptance of its bid, appellant liquidated the preferred stock portfolio in

order to pay the bid price for CalFarm. Appellant subsequently issued its own preferred stock which raised roughly \$135 million; from that money, appellant contributed \$80 million to ZIC, paid \$32 million to repay other bank loans and invested roughly \$23 million in other short term securities and preferred stock.

During the subject income years, appellant deducted interest expense stemming directly from the debentures of \$2,815,886 in 1982, \$8,597,697 in 1983, \$8,333,261 in 1984, and \$8,439,205 in 1985. While holding the portfolio, appellant also incurred administrative and banking expenses which it claims were necessary to monitor and maintain the portfolio, and which it also seeks to deduct as allocable to the taxable income stemming from the portfolio.

Section 24425 precludes a deduction for any amount, "which is allocable to one or more classes of income not included in the measure of the [Bank and Corporation] tax." The Internal Revenue Code (hereafter IRC) contains a similar provision at section 265(a)(1), which precludes a deduction for expenses allocable to tax exempt income (other than tax exempt interest income). (*See* Treas. Reg. § 1.265-1(a)(1).) The purpose of these allocation provisions is to separate excludable income from includible income, in order that a double exemption may not be obtained through the reduction of includible income by expenses incurred in the production of wholly excludable income. (*Great Western Financial Corp. v. Franchise Tax Board* (1971) 4 Cal. 3d 1, 6.)

The parties agree that Internal Revenue Service (hereafter IRS) regulations supporting IRC section 265(a)

provide the proper test to resolve this appeal. Those regulations provide as follows:

[1] Expenses and amounts otherwise allowable which are *directly allocable* to any class or classes of exempt income shall be allocated thereto; and [2] expenses and amounts *directly allocable* to any class or classes of nonexempt income shall be allocated thereto. [3] If an expense or amount otherwise allowable is *indirectly allocable* to both a class of nonexempt income and a class of exempt income, a *reasonable proportion* thereof determined in the light of all the facts and circumstances in each case shall be allocated to each.

(Treas. Reg. § 1.265-1(c) (1958) [emphasis added].) Appellant argues that the debenture interest expense can be *directly* allocated to the income generated by its preferred stock portfolio, and is therefore deductible. Appellant also argues that prior Board opinions establish a purpose and/or use test for determining the means by which certain expenses may be allocated to income-producing activities. Regardless of the applicable test, appellant argues that its dominant purpose for incurring the interest expense was to finance taxable activities, and that in fact, it did use the debenture proceeds for such activities.

In support of its position that this Board should look to the taxpayer's purpose in securing the debenture proceeds (and incurring the related interest), appellant refers to the *Appeal of Southern California Central Credit Union*, decided by this Board on February 3, 1965. In that case, the Board determined that the taxpayer's purpose in securing funds was to meet the demands of its credit union members for loans. Therefore, the Board allocated

the cost of borrowing such funds to business done with the members, a non-taxable activity. On that basis, the interest expense incurred in connection with those funds could not be deducted against taxable income.² (See also *Appeal of Los Angeles Firemen's Credit Union, Inc.*, Cal. St. Bd. of Equal., June 28, 1966.) According to appellant, if the Board applies this purpose test to the instant case, it should prevail based on the evidence of its intent at the time it issued the debentures and acquired the preferred stock portfolio.

Both parties suggest that this Board may have adopted a use test for purposes of determining the deductibility of certain expenses. Pursuant to the use test, "the question is what income did the expense in controversy help to produce, not what use was the income put to." (*Appeal of Mission Equities Corp.*, Cal. St. Bd. of Equal.,

² Respondent suggests that it is not clear that the *Appeal of Los Angeles Firemen's Credit Union, Inc.*, *Infra*, adopts a "purpose" test. Regardless of the precise holding of that opinion, it is clear from the language of the opinion that the Board relied heavily on the taxpayer's exempt purpose for obtaining the funds in reaching a decision. Respondent further suggests that the opinion is distinguishable from the instant case because it concerns a credit union; while that factual difference is obvious, it is not significant. We are here concerned with the allocation principles discussed in that case, not the factual similarities (or lack thereof).

Jan. 7, 1975.)³ In our opinion, the use test, arguably suggested by the *Mission Equities* decision, amounts to an accounting test which seeks to trace the application of the subject funds. We do not view that test as distinct from the purpose inquiry set forth in our other opinions. Rather, and as will be explained later, the two inquires [sic] are complementary for purposes of establishing the proper allocation of interest expense. (See *E.F. Hutton Group, Inc. v. United States* (1987) 811 F.2d 581, 584.)

Appellant also argues that various IRS pronouncements support its position. More specifically, Revenue Ruling 83-3 addresses the deductibility of expenses paid from tax exempt income; the ruling suggests certain allocation methods based on the purpose of the underlying expenditures. (Rev. Rul. 83-3, 1983-1 C.B. 72.) Appellant further cites Revenue Procedure 72-18, which discusses IRC section 265(a)(2) and sets forth guidelines for allocating indebtedness and the related interest expense between tax-exempt securities and other taxable activities. That procedure implements the allocation process by focusing on the taxpayer's purpose in acquiring the indebtedness as demonstrated by all of the facts and circumstances, including the actual use of the debt proceeds. (Rev. Proc. 72-18, 1972-1 C.B. 740; see also Treas. Reg. § 1.265-2(a).)

³ After enunciating this rule, the Board based its final determination on the fact that the taxpayer's subsidiary had already deducted expenses in connection with the excluded income. For that reason, the Board found that it would be improper to allow a double deduction, one for the subsidiary and one for the parent, in connection with the same income.

In contrast to appellant's position, respondent argues that interest, by its nature, is not susceptible to direct allocation. In other words, respondent contends that because money is fungible, such that money generated from two distinct sources is indistinguishable once it is placed in the same fund, any determination regarding the purpose or use of the debenture proceeds will be tenuous at best, and of only limited value for allocation purposes. Further, because the interest expense stems from money which is subject to the discretionary use of the taxpayer, the interest expense simply cannot be directly allocated to a particular class of income, rather, the expense contributes to all aspects of the corporate operations. (See *Appeal of Pacific Associates, Inc.*, Cal. St. Bd. of Equal., Feb. 2, 1976.) For these reasons, when applying Treasury Regulation section 1.265-1(c), *supra*, respondent argues that interest may only be *indirectly* allocated by way of a formula which allocates a reasonable portion of the interest expense to both taxable and nontaxable of income.

Respondent also argues that appellant's various uses of the debenture proceeds for items unrelated to the preferred stock, such as the short term loan to ZIC or the CalFarm purchase, demonstrate that appellant never intended to restrict those funds to one taxable purpose. Respondent also contends that these additional transactions support its position that the associated interest expense is difficult (if not impossible) to allocate between appellant's various income-producing activities. Finally, according to respondent, the fact that appellant chose not to use the proceeds from the preferred stock to retire the debentures constitutes further evidence that appellant

intended to use the funds for both taxable and nontaxable purposes.

Each party presents valid arguments in support of its position, and each argument is founded upon meritorious considerations. It is our opinion that the principles set forth in Revenue Procedure 72-18 best implement all of those considerations, will provide the most workable solution over the long term, and are not inconsistent with our existing opinions in this area. Revenue Procedure 72-18 focuses on the taxpayer's dominant purpose for *incurring and continuing* the subject indebtedness, but also considers the actual use of the debt funds as strong evidence of that purpose.⁴ "Direct evidence of a purpose to purchase tax-exempt obligations [or taxable investments] exists where the proceeds of indebtedness are used for, and are directly traceable to, the purchase." (Rev. Proc. 72-18, *supra*, § 3.02 and 3.03.)

In the absence of direct evidence linking indebtedness with a particular purchase, the IRS, and this Board, will determine whether the totality of the facts and circumstances establish a sufficiently direct relationship between the borrowing and the investment to allow for a direct allocation between those two items. (Rev. Proc. 72-18, *supra*, § 3.04.) Unless the taxpayer can establish its

⁴ We understand that IRC section 265(a)(2), by its terms, applies to tax exempt obligations and does not necessarily apply to the case at hand. However, we also note that section 265(a)(2) and its supporting regulatory scheme concern the allocation of interest expense between taxable and nontaxable activities. For that reason, we find that Revenue Procedure 72-18, and the principles upon which it relies, provide the most helpful framework within which to resolve the present case.

dominant purpose and a sufficiently direct relationship between the expense and the income, respondent's allocation formula will provide the best means to allocate interest expense between taxable and nontaxable activities. Further, due to the factual nature of the inquiries presented by this analysis, it is also clear that the taxpayer must carry the general burden of proving its dominant purpose for incurring and/or continuing the subject obligations (and the related interest expense), as well as the burden of demonstrating the actual use of the subject funds, by tracing or some other method.

Applying these rules to the instant case, we find that appellant has established a dominant purpose sufficient to allow for a direct allocation of its interest expense for the 1982, 1983 and 1984 income years, but has not done so with regard to the 1985 income year.

Regarding 1982, 1983 and 1984, the declarations submitted by appellant, as well as the live testimony of appellant's president, clearly establish appellant's motivation for incurring, and continuing, the debenture interest expense as well as its intentions for the debenture proceeds. That motivation is further established by the uncontroverted evidence that appellant used all of the debenture proceeds to acquire a portfolio of preferred stock within six months of the debenture issue date. Because appellant realized taxable income from that preferred stock, the interest incurred in carrying the debenture obligations is directly allocable to the taxable income generated by the preferred stock portfolio, and is therefore deductible.

Respondent argues that appellant's use of the debenture funds to support ZIC during the 1983 income year, either through direct financing or through loan guarantees, is inconsistent with appellant's asserted dominant purpose. Respondent's point is not without merit; however, a temporary diversion of funds will not, of itself, alter the dominant purpose for incurring the indebtedness represented by the debentures. (Rev. Proc. 72-18, *supra*, § 3.02.) Further, once purchased, appellant never sold any of the preferred stock in order to finance the loans to ZIC, and each of the subsequent loans to ZIC generated *taxable* interest income at the market rate. Finally, the simultaneous pursuit of two activities is not, in and of itself, sufficient to trigger a disallowance of the expense under the applicable statute; the taxpayer may still offer sufficient evidence to allow for a direct allocation. (*Handy Button Machine Co. v. Commissioner* (1974) 61 T.C. 846, 852.)

Respondent points out that interest is traditionally considered an indirect expense for financial accounting purposes, which by definition cannot be directly allocated to a particular item or activity. First, financial accounting is distinct from tax accounting and will take us only so far in arriving at a legal conclusion. Second, we recognize that the distinction between direct and indirect expenses, and the allocation of those expenses, can be difficult. However, such complexities should not preclude a taxpayer from presenting sufficient evidence to obtain a proper tax benefit; slavish adherence to somewhat arbitrary rules should not come at the cost of the

correct result.⁵ Finally, respondent suggests that its reasonable formula provides certainty and eases its administrative burden. While formulas are often easier to implement, the burden of producing evidence sufficient to demonstrate the requisite dominant purpose still rests with the taxpayer; therefore, we conclude that our holding does not unnecessarily add to respondent's existing administrative burden.

As to the 1985 income year, we are not satisfied that appellant maintained, or continued with, the dominant purpose sufficient to allocate the subject interest expense entirely to income from its "taxable" activities. The facts demonstrate that appellant sold nearly all of its preferred stock portfolio in order to acquire CalFarm; it did not use the proceeds to retire the debentures, rather, it acquired yet another insurance company whose income is not subject to the California Bank and Corporation Tax. After liquidating the preferred stock portfolio, appellant issued its own preferred stock and raised roughly \$135 million. Of that amount, appellant contributed \$80 million to ZIC, repaid \$32 million in other bank loans and invested roughly \$23 million in other short term securities and preferred stock. The record does not contain a detailed breakdown of the type of securities acquired by appellant, but it is evident that the nature of appellant's holdings changed dramatically as a result of the CalFarm

⁵ While it should be evident, this rule may also operate to the detriment of a taxpayer whose purpose in incurring certain debt is sufficiently clear that the related interest expense may be directly allocated to tax exempt income.

acquisition. In short, we lose sight of the debenture proceeds in 1985. For that reason we are no longer content to rely on appellant's original dominant purpose for continuing the debt, and we find that the interest expense is no longer directly allocable to income from appellant's taxable activities. For these reasons, appellant's 1985 interest expense should be allocated in accordance with the formula utilized by respondent in arriving at its assessment for that income year.

As one final matter, the parties also dispute the proper allocation of administrative expenses incurred by appellant in connection with the debentures and the preferred stock portfolio. We find that these expenses should be allocated in the same manner as the interest expense based on the rationale set forth above.

Based upon the above analysis and factual conclusions, we hereby reverse respondent's determination as to the 1982, 1983 and 1984 income years, and affirm its determination as to the 1985 income year.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Zenith National Insurance Corporation against proposed assessments of additional franchise tax in the amounts of \$50,110.24, \$199,271.49, and \$207,646.62 for the income years ended December 31, 1982, December

31, 1983, and December 31, 1984, respectively, be and the same is hereby reversed, and that the Franchise Tax Board's action on the protest against the proposed assessment of \$254,690.00 for the income year ended December 31, 1985, be sustained.

Done at Sacramento, California, this 8th day of January, 1998, by the State Board of Equalization, with Board Members Mr. Andal, Mr. Klehs, Mr. Dronenburg, Mr. Halverson* (not participating) and Mr. Chiang** present.

* For Kathleen Connell, per Government Code section 7.9.

** Acting Member, 4th District.

In the Matter of the Appeal of
Zenith National Insurance Corp.

No. 94A-0767

STATE BOARD OF EQUALIZATION OF THE
STATE OF CALIFORNIA

1998 Cal. Tax LEXIS 651; 98-SBE-001-A

June 25, 1998

OPINION BY: PER CURIAM

ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition filed February 3, 1998, by the Franchise Tax Board for a rehearing of appellant's appeal from the action of the Franchise Tax Board, we agree that our prior opinion dated January 8, 1998, is subject to clarification and we take this opportunity to do so.

As indicated in our opinion of January 8, 1998, interest expense shall be allocated between taxable and tax-exempt income in accordance with the principles set forth in Revenue Procedure 72-18. (Rev. Proc. 72-18, 1972-1 C.B. 740.) Acknowledging that the preferred stock portfolio in the instant case remained relatively stable in value until July of 1985, and consistent with the principles set forth in Revenue Procedure 72-18 it is clear that appellant maintained the same dominant purpose through June of 1985, and that appellant's allowable interest expense for the 1985 income year should be decreased in the manner proposed by both parties.

Regarding respondent's request that we modify the language at page four, paragraph three, line two, of the opinion to refer specifically to Internal Revenue Code

section 265(a)(1), rather than to section 265(a), we express no opinion as to the merits of that suggestion, but choose not to amend our opinion in that regard.

Aside from the clarifications contained in this order, we are of the opinion that none of the grounds set forth in the petition for rehearing constitute cause for the granting thereof and, accordingly, it is hereby ordered that the petition be and the same is hereby denied, and we direct that our order of January 8, 1998, be and the same is, hereby affirmed.

Done at Sacramento, California, this 25th day of June, 1998, by the State Board of Equalization, with Board Member Mr. Andal, Mr. Klehs, Mr. Dronenburg and Mr. Chiang* present, Ms. Mandel** not participating.

* Acting Member, 4th District.

** For Kathleen Connell, per Government Code section 7.9.

DEC 10 1999

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No. 98-2043

Supreme Court, U.S.
FILED
DEC 10 1999

OFFICE OF THE CLERK

In The
Supreme Court of the United States

— ♦ —
HUNT-WESSON, INC.,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

— ♦ —
**On Writ Of Certiorari To The
Court Of Appeal Of California
For The First Appellate District**

— ♦ —
BRIEF FOR RESPONDENT

— ♦ —
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QUESTION PRESENTED

California permits a corporation engaged in business in the State to deduct from its taxable income all interest paid or accrued within a taxable year on indebtedness incurred in the production of that income. For a corporation engaged in business both in and out of California, the amount of the interest deduction taken into account by California is statutorily determined. Cal. Rev. & Tax. Code § 24344. This statute is designed to close a judicially acknowledged tax loophole by preventing a corporation from obtaining a double tax benefit by investing its own business capital in nonbusiness activities which generate dividends and interest income exempt from California taxes, while simultaneously operating its business on borrowed funds, thereby generating an interest expense deduction for itself. California attempts to curtail this practice by prescribing an ordering rule for matching a corporation's interest expense with the category of income, including dividend and interest income from investments, to which the indebtedness is attributable. Against this background, the following question is presented:

Whether California's statutory method of allocating a corporation's interest expense to business and nonbusiness income for the purpose of calculating its apportionable business income subject to California tax is constitutionally permissible.

LIST OF PARTIES

Petitioner is Hunt-Wesson, Inc. ("Hunt-Wesson"). In proceedings before the California courts, petitioner has been referred to as Hunt-Wesson, Inc., Successor in Interest to Beatrice Companies, Inc., and as Hunt-Wesson, a Successor by Merger with Beatrice Company, formerly known as CagSub, Inc., a Successor in Interest to Beatrice Companies, Inc., formerly known as Beatrice Foods Company.

Respondent is the Franchise Tax Board for the State of California ("Board").

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OPINIONS BELOW

The Opinion of the California Court of Appeal is found in the Joint Appendix ("J.A.") at 54-66. The proposed statement of decision of the California Superior Court, City and County of San Francisco, is located at J.A. 33-53. The California Supreme Court's denial of Hunt-Wesson's petition for review is found at J.A. 67. None of the above-referenced opinions was officially reported.

STATEMENT OF JURISDICTION

The California Court of Appeal entered judgment in favor of the Board on December 11, 1998. J.A. 54-66. The California Supreme Court denied Hunt-Wesson's petition for review on March 24, 1999. J.A. 67. Hunt-Wesson's petition for certiorari was filed on June 22, 1999, and was granted on September 28, 1999. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Due Process Clause of the Fourteenth Amendment of the United States Constitution, U.S. Const., amend. XIV, § 1, provides that "No State shall . . . deprive any person of life, liberty, or property, without due process of law."

The Commerce Clause of the United States Constitution, U.S. Const. art. I, § 8, cl. 3, provides that "Congress shall have Power . . . [t]o regulate Commerce . . . among the several States."

During fiscal years 1980 through 1982, the relevant years at issue, California Revenue and Taxation Code section 24344 provided as follows:

(a) Except as limited by subsection (b), there shall be allowed as a deduction all interest paid

or accrued during the income year on indebtedness of the taxpayer.

(b) If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under Section 24402) not subject to allocation by formula.¹

STATEMENT OF THE CASE

This is an action for refund of California franchise taxes collected from Hunt-Wesson, a corporation engaged in business throughout the world, including California, during fiscal years ended 1980 through 1982 ("years in issue"). Hunt-Wesson seeks a refund of \$1,523,462 and applicable interest thereon.

A. California's method of taxing multistate corporations

California imposes a franchise tax on every corporation doing business within the State. Cal. Rev. & Tax. Code § 23151. When a corporation derives its income

¹ Statutory differences between the current version of section 24344 and the version in effect during the years in issue here are not relevant. The words "allocation by formula" are interpreted to mean "apportionment by formula," the statutory term currently used.

from sources both in and out of California, its tax is measured by net income derived from or attributable to sources within California. Cal. Rev. & Tax. Code § 25101. The amount of a corporation's net income derived from or attributable to sources within California is determined pursuant to the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA). Cal. Rev. & Tax. Code § 25120 *et seq.* Under the UDITPA provisions, multi-state corporations are potentially subject to tax from two streams of income: (1) business income, and (2) nonbusiness income attributable to taxable activities within the State.² A multistate corporation's total income equals the sum of these two streams of income.

When a multistate corporation is engaged in a unitary business, its worldwide business income is apportioned among the various states by use of an apportionment formula.³ Cal. Rev. & Tax. Code §§ 25121 & 25128. California has adopted a standard apportionment formula under which income is apportioned to the State by reference to the total aggregate business income of the entire group of corporations which comprise the unitary business. Net business income is derived by deducting allocable expenses from total business income.

² Business income is defined as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Cal. Rev. & Tax. Code § 25120(a). Nonbusiness income is defined as all income other than business income. Cal. Rev. & Tax. Code § 25120(d).

³ This Court has described a unitary business as a functionally integrated enterprise whose parts are characterized by substantial mutual interdependence and a flow of value. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 178-179 (1983).

Nonbusiness income and expenses are not subject to apportionment, but instead are allocated entirely to a single state.⁴ Cal. Rev. & Tax. Code §§ 25123-25127. Nonbusiness income in the form of dividends and interest is generally allocable to the state where the taxpayer is commercially domiciled.⁵ See Cal. Rev. & Tax. Code §§ 25123 & 25126.

B. California Revenue and Taxation Code section 24344(b)

Section 24344(b) of the California Revenue and Taxation Code allows for California franchise tax purposes a deduction for "interest paid or accrued on indebtedness" incurred by a corporation whose income is derived from sources both in and out of the State. The corporation's tax is measured by net income derived from or attributable to sources within California. Cal. Rev. & Tax. Code § 25101. By its terms, section 24344(b) applies only to a corporation doing business both in and out of California and whose California business income is determined by the application of apportionment principles. Section 24344(b) also provides a formula, known as the "interest offset" provision, for calculating the amount of interest expense which a corporation may deduct against its business income in California.

Contrary to Hunt-Wesson's erroneous allegation that section 24344(b) is applied only to what it mischaracterizes as "business interest expense" (Petitioner's Brief

⁴ This Court has held that California's statutory treatment of business and nonbusiness income satisfies due process requirements. *Container Corp.*, 463 U.S. at 167, 180-84.

⁵ Certain types of nonbusiness income, such as capital gains on sales of real property, are allocated not on the basis of domicile, but situs. See Cal. Rev. & Tax. Code §§ 25123-25127.

("Pet. Br.") at 25), the statute is applied to all "interest" expense paid or accrued on indebtedness as follows:

First, interest expense incurred on indebtedness by a corporation is attributed to its business income (*i.e.*, income subject to apportionment by formula) to the extent that the corporation has earned interest income from its business operations. This amount of interest expense is fully deductible against the corporation's business income that is apportioned to California.

Second, the balance, if any, of the corporation's interest expense is attributed to, or offset by, any nonbusiness interest and dividend income (*i.e.*, income not subject to the apportionment formula) from investment activities.⁶

Third, any remaining interest expense in excess of the corporation's nonbusiness interest and dividend income is fully deductible against apportionable business income.⁷

A simplified example illustrates the manner in which the "interest offset" provision of California's statute is applied. Assume in a taxable year that a corporation is engaged in a unitary business in and out of California and has \$1,000 of interest expense from debt, \$250 of

⁶ Dividends which are deductible pursuant to Cal. Rev. & Tax. Code § 24402 are excluded from the statutory formula. Section 24402 provides for a deduction to the recipient of dividends declared from income which has been "included in the measure of the taxes imposed . . . upon the taxpayer declaring the dividends."

⁷ Generally, the residual interest expense is deductible against the corporation's apportionable business income. In certain cases not pertinent here, the remaining interest expense may also be available as a deduction against the corporation's nonbusiness income (exclusive of nonbusiness interest and dividend income already offset under the interest offset statute). See Cal. Code of Regs. tit. 18 § 25120(d).

interest income from business operations and \$300 of investment income from nonbusiness stocks and bonds. Under the statute, the \$1,000 of interest expense is first attributed to and deductible against the corporation's total unitary business income to the extent of the corporation's business interest income, *i.e.*, \$250. Second, of the remaining \$750 (\$1,000 less \$250) of interest expense, \$300 is attributed to and offset by the corporation's \$300 of nonbusiness income. (By this process, the remaining \$750 of interest expense available as a potential deduction against the corporation's apportionable business income is reduced by \$300.) Finally, the \$450 (\$750 less \$300) balance of interest expense is deductible against the corporation's unitary business income. Thus, a total of \$700 (\$250 plus \$450) of the \$1,000 interest expense is deductible against the corporation's total unitary business income apportionable to California. The remaining \$300 is allocated to the corporation's nonbusiness income, which is taxable in its state of domicile.

C. California's interest offset statute as applied to Hunt-Wesson

Hunt-Wesson is a corporation incorporated in Delaware and domiciled in Illinois. J.A. 18 (Stip. ¶ 1).⁸ A diversified food company producing a wide range of food and food-related products and services for worldwide markets, Hunt-Wesson is engaged in business both in California and throughout the world. J.A. 18 (Stip. ¶ 2).

During the three years in issue, Hunt-Wesson earned income in the form of interest from its unitary business operations in the amounts of approximately \$10 million,

⁸ References to the Joint Stipulation of Facts in this case are denominated "Stip." followed by a paragraph reference.

\$21 million and \$84 million respectively. Clerk's Transcript ("CT") 8, 120.

Hunt-Wesson owned a number of dividend-paying subsidiaries, none of which was a member of Hunt-Wesson's unitary business group of corporations. J.A. 19 (Stip. ¶ 7). These subsidiaries paid dividends to Hunt-Wesson during the three years in issue in an amount approximating \$27 million, \$29 million and \$19 million respectively. J.A. 19 (Stip. ¶ 7). Hunt-Wesson treated all of these dividends as nonbusiness income not subject to tax by California. J.A. 19 (Stip. ¶ 8).

Hunt-Wesson also incurred interest expense from loans during the three years in issue in the approximate amounts of \$80 million, \$55 million and \$137 million respectively. J.A. 19-20 (Stip. ¶ 10). None of the interest expense incurred was reported by Hunt-Wesson as assignable to the approximately \$75 million of total nonbusiness dividend income which Hunt-Wesson received during the years in issue. Rather, Hunt-Wesson claimed that the entire amount of the approximately \$273 million of interest expense incurred during the years in issue was attributed to, and fully deductible against, its business income subject to California franchise tax. J.A. 20 (Stip. ¶ 10).

Following an audit of the years in issue, and by operation of California's interest offset provision, the Board authorized Hunt-Wesson to deduct nearly \$198 million of the approximately \$273 million of interest expense against its business income apportionable to California. See Appendix to Brief for Respondent ("App.") at 1a *infra*. The Board computed Hunt-Wesson's interest expense deduction adding the amount of interest expense equal to its business interest income and the amount by

which the remaining interest expense exceeded its non-business dividend income.⁹ The balance of the interest expense was attributed to and offset by the amount of Hunt-Wesson's nonbusiness dividend income. J.A. 19-20 (Stip. ¶¶ 7, 10-12). Because the nonbusiness dividends were not subject to taxation in California pursuant to the UDITPA provisions, the interest expense attributed to those dividends did not reduce the amount of Hunt-Wesson's California business income.

As a result of the amount of interest expense deductions claimed by Hunt-Wesson, the Board assessed a tax deficiency against Hunt-Wesson for each of the three years in issue. J.A. 21 (Stip. ¶ 16). Hunt-Wesson paid the deficiencies and filed an administrative claim for refund with the Board. J.A. 22 (Stip. ¶¶ 18 & 21). The claim for refund was denied. J.A. 23 (Stip. ¶ 22).

D. The California Superior Court decision

Hunt-Wesson filed a suit for tax refund in the California Superior Court. In its complaint, Hunt-Wesson challenged the constitutionality of California Revenue and Taxation Code section 24344(b) on the grounds that it violated the Due Process Clause, Commerce Clause and Equal Protection Clause of the Constitution.

Following a trial, the superior court entered judgment in favor of Hunt-Wesson on several grounds.

First, although acknowledging that this Court has historically taken a "symmetrical view" of taxation in which income and expenses are paired so that a taxpayer should not be permitted to deduct expenses related to generating income exempt from taxation, the superior

⁹ Although the California statute refers to "interest and dividend income . . . not subject to allocation by formula," all of the nonbusiness income at issue here is dividend income.

court found that California's statute violated due process because it attributed interest expense to non-taxable dividend income without regard to whether such interest was related to the dividend income. J.A. 43-46.

Second, by virtue of the fact that Hunt-Wesson's nonbusiness dividend income was taxable only by Illinois, the state of its domicile, the superior court declared that the statute operated impermissibly to tax a foreign corporation more than a similarly situated domestic corporation, thus interfering with interstate commerce. J.A. 46-48.

Finally, the superior court stated that its finding that the statute applied unequally to domestic and foreign corporations compelled the conclusion that the statute violated equal protection. J.A. 49-51. The Board appealed.

E. The California Court of Appeal decision

Relying in large part on the California Supreme Court's decision in *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 7 Cal.3d 544, 498 P.2d 1030 (1972) ("*Pacific Telephone*"), the California Court of Appeal ruled that section 24344(b) was constitutional and reversed the judgment of the superior court. J.A. 54-66.

The court of appeal first acknowledged that the "theory of the interest offset rule [of section 24344(b)] is that a corporation should not be able to borrow money to purchase stocks that pay dividends and then get a deduction for the interest while the dividend income (being investment or nonbusiness income) is not taxable. [Citation.]" J.A. 58. Consistent with this theory, the court of appeal observed that the California Supreme Court in *Pacific Telephone* had ruled that the California Legislature had acted reasonably in treating interest expense as the opposite of dividend income and by requiring the offset of one against the other. J.A. 58. The court of appeal

noted that the California Supreme Court in *Pacific Telephone* clearly was aware that the dividend income of a foreign corporation is not taxable in California. J.A. 61. However, the California Supreme Court determined that such income nevertheless fell within the language and logic of the statute, which was designed to offset interest expense against investment income. J.A. 59. Quoting from *Pacific Telephone*, the court of appeal declared that a finding in favor of Hunt-Wesson would result in the creation of a tax loophole whereby a foreign corporation would be able to "borrow money and build up its interest expense deduction and then receive tax exempt dividends on the basis of investments made with the borrowed money." J.A. 59.

The court of appeal rejected Hunt-Wesson's contention that the statute operated to tax indirectly income not subject to California taxation. J.A. 61. In so ruling, the court of appeal relied on the California Supreme Court's finding in *Pacific Telephone* that the inclusion of non-taxable dividends in the statutory computation did not constitute taxation of the dividends themselves, which were reasonably applied to offset the interest expense deduction. J.A. 59. Quoting again from *Pacific Telephone*, the court of appeal declared that "California has a substantial interest in making sure that income attributable to this state is not distorted by use of the interest expense deduction, and under subsection (b), the dividends received are only taken into account to offset the interest expense deduction." J.A. 59.

Hunt-Wesson's claim that the California statute facially discriminated against interstate commerce was also rejected. J.A. 62-65. The court of appeal ruled that this contention collided with the holding in *Pacific Telephone* that the statute does not operate to impose a tax on non-taxable investment income. J.A. 62. The court of

appeal also distinguished several of this Court's decisions dealing with facially discriminatory statutes, including *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), in which this Court invalidated North Carolina's intangibles tax. J.A. 62-63. Unlike *Fulton*, the deductibility of interest expense under the California statute was determined not by Hunt-Wesson's domicile, but rather by the character of the income attributable to that expense. J.A. 62-63. Any favoritism shown to domestic corporations was indirect and incidental. J.A. 62. Moreover, California's statute was part of an overall apportionment scheme which did not distinguish between domestic and foreign corporations and the "same rules and logic of offsetting interest expense against investment income are applied to both." J.A. 62.

The court of appeal furthermore rejected Hunt-Wesson's claim that the California statute discriminates by parenthetically omitting from the interest offset computation dividends declared from income already taxed to the dividend payor by California. J.A. 64; see n. 6, *supra*. Since the State had already taxed the dividends in question, no unconstitutional discrimination resulted from California's efforts to refrain from double taxation. J.A. 64. In contrast to *Fulton*, the California statute did not waive an otherwise uniform intangibles tax based entirely on the percentage of the underlying corporate income taxed by the State. Rather, the statute operated as "part of an overall apportioned tax scheme, matching expenses with income in a manner which our Supreme Court has determined to be reasonable." J.A. 64.

Finally, Hunt-Wesson's equal protection claim was rejected. The court of appeal determined that the California statute did not create an arbitrary classification based

on domicile, but rather was rationally related to California's need to close a "gaping tax loophole." J.A. 65.¹⁰

F. The California Supreme Court decision

Hunt-Wesson sought review of the California Court of Appeal's decision. The California Supreme Court denied Hunt-Wesson's petition for review on March 24, 1999. J.A. 67.

SUMMARY OF ARGUMENT

California permits a corporation subject to tax in the State to deduct from its taxable income all interest paid or accrued within a taxable year on indebtedness incurred in the production of that income. However, like many states, California does not allow a deduction of interest expense that is attributable to the production of income which the State is barred from taxing. Because money is fungible and cannot be readily traced to its ultimate application, California applies a formula by which interest expense incurred by a corporation doing business both in and out of the State is statutorily allocated to classes of income. California's statute fairly and rationally allocates a corporation's interest expense to its taxable and non-taxable income by the measure of specific kinds of income realized by the corporation from both business activities and nonbusiness (or investment) activities. This statute is intended to plug a destructive tax loophole by which a corporation may obtain a double tax benefit by investing its own business capital in nonbusiness activities which generate income exempt from California taxes, while simultaneously operating its business on borrowed

¹⁰ Hunt-Wesson has not pursued its equal protection claim in this Court. Pet. Br. at 12 n. 13.

funds, thereby generating an interest expense deduction for itself.

Hunt-Wesson concedes that "interest expense should be allocated to the income it helps produce." Pet. Br. at 23. Furthermore, it claims to have no quarrel with a formula which fairly assigns interest expense to related income. *See* Pet. Br. at 25-32. Hunt-Wesson nevertheless insists that not one dollar of the indebtedness which generated more than \$273 million of interest expense during the years in issue was attributable, either directly or indirectly, to the production of approximately \$75 million of non-taxable dividends by its nonunitary subsidiaries. In attempting to justify this position, Hunt-Wesson attacks California's particular statutory method of matching interest expense to classes of income as irrational and resulting in the indirect taxation of non-taxable income.

Hunt-Wesson seeks to support its contentions by misstating the manner in which California's statute is applied. Hunt-Wesson also seeks in essence to have this Court "constitutionalize" a particular method for allocating interest expense by pointing to various "fair" interest allocation formulas utilized by other jurisdictions. However, Hunt-Wesson is silent as to how any of these other formulas is more "fair" than California's statute and makes no showing that it would be entitled in fact to a greater tax deduction under any of these methods than under California's statute. By embracing these alternative formulas which, similar to California's statute, assign interest expense to taxable income by reference to non-taxable investment activities, Hunt-Wesson indirectly acknowledges the rational relationship between interest expense and non-taxable income stemming from the fungible nature of money which is the foundation of California's statute.

What Hunt-Wesson attempts to characterize as a violation of California's jurisdiction to tax is in fact a complaint about California's long-standing formula for allocating deductible interest expense to business-related income, which the State indisputably is empowered to tax. California's statute does not impose a tax on a corporation's non-taxable investment income, either directly or indirectly. Rather, the statute allocates interest expense from indebtedness to business income and nonbusiness income in a manner which reflects economic reality. By so doing, California seeks to ensure that a corporation engaged in business in the State pays its fair share of taxes.

Hunt-Wesson also challenges California's statute on the ground that it discriminates against interstate commerce by favoring domestic corporations over foreign corporations. In fact, the statute is applied identically to domestic and foreign corporations alike – interest expense is allocated to business and nonbusiness income in the same manner and to the same extent regardless of where the corporation is domiciled – and is neutral on its face. The statute aims to ensure that a corporation that invests in non-taxable activities while simultaneously operating on borrowed funds and a corporation that operates on its own capital without such investments are similarly situated for State tax purposes. The statute furthermore meets the constitutional test of "internal consistency" – if every jurisdiction in which Hunt-Wesson was taxable utilized a statute identical to California's, Hunt-Wesson would realize the full benefit of each dollar of interest expense which it incurred against its worldwide income. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983); *Armco, Inc. v. Hardesty*, 467 U.S. 638, 644-45 (1984).

Hunt-Wesson seeks to live in a world where a corporation may freely manipulate the amount of its income subject to California tax through the mere act of borrowing. If Hunt-Wesson is successful, it will have succeeded in improperly using the Constitution as a shield, not against improper taxation, but against constitutionally permissible taxation. Historically, this Court has repeatedly affirmed the principle that interstate commerce may be made to pay its fair share of taxation without running afoul of the Commerce Clause. Hunt-Wesson should not be constitutionally permitted to depart from this well-established principle.¹¹

ARGUMENT

I.

CALIFORNIA'S INTEREST OFFSET STATUTE, WHICH ALLOCATES A CORPORATION'S INTEREST EXPENSE TO ITS BUSINESS AND NONBUSINESS INCOME IN A RATIONAL AND FAIR MANNER, DOES NOT TAX INCOME EXEMPT FROM STATE TAXATION

It is a well-settled principle of constitutional jurisprudence that a taxing jurisdiction bears no obligation to allow a tax deduction for an expense relating to income which that jurisdiction is barred from taxing. Indeed, Hunt-Wesson itself "takes no issue with the widely accepted principle that interest expense should be allocated to the income that it helps produce." Pet. Br. at 23. Hunt-Wesson nevertheless insists that not one dollar of the indebtedness which generated the more than \$273

¹¹ The issues raised in this case have also been raised in *F. W. Woolworth Co. and Kinney Shoe Corp. v. Franchise Tax Board*, No. 98-1967 (Petition for Writ of Certiorari filed June 7, 1999), which is currently pending before this Court.

million of interest expense incurred during the years in issue was attributable in any way to production of the approximately \$75 million of non-taxable dividends by its nonunitary subsidiaries.

In defining the limits to which an expense may be assigned to income not subject to taxation, this Court has repeatedly declared that the immunity from taxation need not be total, but may instead be limited by charging such non-taxable income with its fair share of related expenses. See *Denman v. Slayton*, 282 U.S. 514 (1931) (federal tax statute permitting deduction of interest expense on indebtedness except as to indebtedness incurred to purchase or carry tax-exempt securities upheld as constitutional and reasonable to close tax loophole); *Helvering v. Ind. Life Ins. Co.*, 292 U.S. 371 (1934) (federal tax provisions allowing for deduction of depreciation and expenses of buildings owned by life insurance companies but only on condition that company include in gross income the non-taxable rental value of the space which it occupied upheld as not an improper tax on the tax-exempt rental value, but rather a permissible "apportionment of expenses"); *United States v. Atlas Ins. Co.*, 381 U.S. 233 (1965) (confirmed holdings in *Denman* and *Ind. Life* that "the tax laws may require tax-exempt income to pay its way"); *First National Bank v. Bartow Cty. Tax Assessors.*, 470 U.S. 583 (1985) (state statute limiting deduction of tax-exempt government obligations in determining bank's net worth on which tax was based upheld as constitutional).

Consistent with this principle, the California Legislature enacted California Revenue and Taxation Code section 24344 over 40 years ago on the belief that a corporation doing business in and out of California is entitled to reduce its State tax liability by deducting only that portion of interest costs from indebtedness which is

attributable to the production of income which the State is permitted to tax.¹² This is accomplished by the application of a statutory formula which assigns a corporation's interest expense to income generated from its business and non-business activities.

Under the statute's formula, interest expense is first assigned to and deductible against, on a dollar-for-dollar basis, a corporation's business income to the extent of its interest income generated from business activities. Any remaining interest expense is then attributed to and offset by the corporation's non-business income in the form of dividends and interest. Once this allocation of interest expense to nonbusiness income is completed, the balance, if any, of interest expense is fully deductible against the corporation's business income. By this method, California seeks to fairly and rationally identify that portion of interest expense which is attributable to and deductible against business income apportioned to the State.

The three-step operation of California's interest offset statute can be illustrated by looking at Hunt-Wesson's operations for 1982, one of the years in issue. As a unitary business engaged in business in California and throughout the world, Hunt-Wesson is subject to apportionment of its worldwide business income by formula. In 1982, Hunt-Wesson's total interest expense from its worldwide operations was \$137 million. It earned interest income from its unitary business operations of \$84 million.

Hunt-Wesson also owned dividend-paying subsidiaries, none of which was a member of its unitary business. In 1982, Hunt-Wesson received \$19 million in dividend income from its nonunitary subsidiaries.

Under the first step of the interest offset rule, Hunt-Wesson was entitled to a dollar for dollar deduction of

¹² 1955 Cal. Stat., c. 938, p. 1581, § 20, eff. June 6, 1955.

approximately \$84 million, which is equal to its interest income from its unitary business. This leaves \$53 million in interest expense (\$137 million less \$84 million).

Under the second step, the \$53 million is offset against any nonbusiness interest or dividend income. For Hunt-Wesson in 1982, this reduced the allocable interest expense to \$34 million (\$53 million less \$19 million).

Under the third step, California allows the remaining \$34 million to be deducted, dollar for dollar, against any other apportionable business income. Thus, Hunt-Wesson's total interest expense deduction for 1982 was \$118 million. This amount is available to reduce its total business income. California's apportioned share of total business income is then calculated from this net unitary business income figure.

As earlier noted, the taxation of Hunt-Wesson's non-business income is a matter constitutionally assigned to its state of domicile. Hunt-Wesson is domiciled in Illinois.

California's statutory matching of a corporation's interest expense to its business activities and nonbusiness activities by the measure of its investment income from interest and dividends reasonably reflects how its income is generated. The California Supreme Court has declared:

In treating interest expense as the opposite of investment income (interest and dividend income), the subsection is obviously approaching the problem presented in a reasonable manner. Interest expense is the opposite of interest income, and dividend income is sufficiently analogous to interest income that it is reasonable to provide for the offset of interest expense against dividend income. *Pacific Telephone*, 7 Cal.3d at 551-552, 498 P.2d at 1036.

The California Supreme Court's approval of the Legislature's decision to equate passive income such as interest and dividends with interest expense is rational. Interest

and dividend income represent a source of ready and available cash to a corporation to help defray interest expense. In recognizing the logic of offsetting investment interest and dividend income with interest expense, the California Supreme Court has found that the approach taken by the California Legislature is reasonable. *Id.*

In stark contrast to both the express terms and underlying rationale of section 24344(b), Hunt-Wesson erroneously describes the operation of the statute as first requiring the elimination of nonbusiness interest expense from the interest offset computation. Pet. Br. at 8 & 9. Hunt-Wesson asserts that "under California law, nonbusiness interest expense has already been disallowed as a deduction, and thereby eliminated from the calculus, prior to the application of the interest offset provision." Pet. Br. at 25.

California's statute contains *no such requirement*. Cal. Rev. & Tax. Code § 24344; see *Pacific Telephone*, 7 Cal.3d at 549-550, 498 P.2d at 1034-1035. In applying the interest offset provision to Hunt-Wesson's interest expense for the years in issue, neither Hunt-Wesson nor the Board made any attempt to eliminate "nonbusiness interest expense" from the calculation. See CT 120. If "nonbusiness interest expense" had been removed, application of the formula would have been superfluous because the assignment of interest expense between business and nonbusiness income would have already occurred. Indeed, the matching of interest expense with classes of income is the entire purpose of the statute.¹³

¹³ The Board did *not* stipulate that the elimination of nonbusiness interest expense is a statutory component of the interest offset computation. Hunt-Wesson's assertion to the contrary (Pet. Br. at 8 n. 8) stems from its interpretation of California state tax form Schedule R-5, Form 100, as effective

Similarly, Hunt-Wesson's assertion that the interest offset provision of the California statute is applied only to "business interest expense" (Pet. Br. at 25) is misleading because it assumes that the interest expense being assigned has already been classified as a "business" expense and that none of it relates to nonbusiness income. In essence, Hunt-Wesson is attempting to rewrite the statute with a term of its own creation – "business interest expense" – in an effort to manufacture support for its position. The term "business interest expense" does not appear anywhere in the statute, which refers simply to the allocation of "interest."¹⁴

during the years in issue. J.A. 20 (Stip ¶ 11); CT 70. This form erroneously instructs the taxpayer to identify and subtract its nonbusiness interest expense prior to determining the amount of interest expense attributable to business and nonbusiness income. Although the Board has determined that the form in use during the years in issue does not correctly implement the provisions of the statute and that the form has since been corrected, any confusion created as a result is not constitutionally significant. This Court has held that a taxing agency is empowered retroactively to correct mistakes of law in its application of tax statutes to particular transactions. See *Dixon v. United States*, 381 U.S. 68, 72-73 (1965); *Automobile Club v. Commissioner*, 353 U.S. 180, 183-84 (1957). This reflects the fact that the California Legislature, not the Board, prescribes the State's tax laws. *Dixon*, 381 U.S. at 73. Hunt-Wesson's challenge is directed to the constitutionality of section 24344(b) itself and not to the provisions of state tax form Schedule R-5. In any event, the amount of tax in dispute here is unaffected by any such ambiguity because Hunt-Wesson reported *all* of its interest expense as business interest expense and *none* of it as nonbusiness interest expense. J.A. 19-20 (Stip. ¶ 10).

¹⁴ Although California stipulated that the interest expense reportable on line 3 of state form Schedule R-5 is "business interest expense," it did *not* stipulate that the interest expense bore no relation to the non-taxable dividend income. J.A. 20

A. California's interest offset statute is based on the rationale that money is fungible and cannot be reliably traced to its ultimate use

When a corporation engaged in business both in and out of California incurs debt while simultaneously holding investments which generate non-taxable income, the question arises as to what extent, if any, the corporation should be allowed by the State to deduct the interest costs from the indebtedness. California generally permits a corporate taxpayer to deduct from gross income the interest paid or accrued within the taxable year on indebtedness as an expense incurred in the production of taxable income. Cal. Rev. & Tax. Code § 24344(a). However, if a deduction of the *entire* amount of interest expense is allowed, the corporation stands to gain a tax windfall by reducing its California business income by the full amount of the interest costs, regardless of whether those costs include expenses related to the production of non-taxable income, while at the same time shielding its non-taxable income from State taxation.¹⁵

(Stip. ¶ 11). California furthermore did not stipulate as to the meaning of this term, which is neither defined in the stipulation nor is a part of the statute. The characterization of interest expense subject to the interest offset provision as "business interest expense" is consistent with the calculation format contained in state form Schedule R-5. See CT 70. However, as previously noted, state form Schedule R-5 is not consistent with the statutory formula under consideration here and has since been corrected.

¹⁵ The interest expense deduction reflects California's intent to tax only a corporation's net income rather than gross income. The basis for the interest deduction is undermined when the indebtedness giving rise to the interest expense relates to the generation of income which is non-taxable. Accordingly, California precludes a corporate deduction for any expense

This incongruous result stems from the judicially recognized economic relationship which exists between the interest costs of indebtedness and non-taxable income, a relationship which allows a foreign corporation, such as Hunt-Wesson, to finance its unitary business operations on borrowed capital while at the same time earning non-taxable income by investing its own capital in nonunitary investments. *Pacific Telephone*, 7 Cal.3d at 555, 498 P.2d at 1039. The problem facing California is determining as a practical matter the extent to which the corporation's interest expense is attributable to its California unitary business income and to its nonunitary nonbusiness income.

There is no scientifically precise way to make this determination. Money, by its very nature, is fungible and easily subject to manipulation. To illustrate, assume that a foreign corporation engaged in business both in and out of California is subject to a relatively higher California tax rate than in the other states in which it does business. For tax purposes, it would be advantageous for the corporation to decrease its California income attributable to its business activities and increase its non-taxable investment income. If the corporation borrowed money to invest in stocks and bonds, the interest expense from the indebtedness would be chargeable against the non-taxable income from these investments. However, the corporation might choose instead to purchase the securities with funds which would otherwise be used in its business and then later replace such funds with borrowed money. By this simple expedient, the corporation could

allocable to income not subject to tax by the State. Cal. Rev. & Tax. Code § 24425.

convert what is in reality an expense attributable to non-business income into an expense of doing business and thereby gain a double tax benefit.

Moreover, regardless of a corporation's motive for incurring debt, the accurate tracing of borrowed funds to their ultimate use is virtually impossible. Borrowed funds are typically applied to a variety of general corporate purposes which inevitably encompass both business and nonbusiness activities. A corporation also maintains substantial flexibility as to both the source and use of its funds. The realities of business finance are such that the amount and timing of borrowing rarely, if ever, directly correlate to specific investments, especially where financial transactions are spread out over a number of years.

For these reasons, interest costs cannot be readily traced to a specific business or nonbusiness activity. Typically, as in this case, a corporation will attempt to deduct the entire amount of its interest expense by attributing all of it to the production of its business income and none of it to the production of its nonbusiness income. As a result, the nonbusiness income associated with a portion of the interest costs are not taxed at all, while the interest costs relating to nonbusiness activities are deducted against business income that would be otherwise taxable.

B. This Court's decisions relating to the unitary business principle and the formula apportionment of income among the states provide a proper analytical framework by which to evaluate California's statutory approach to allocating interest expense to business and nonbusiness income

This Court has declared that the constitutionality of a state tax statute "requires an examination of the whole tax structure of the state." *Washington v. United States*, 460 U.S. 536, 542 (1983) (internal quotation marks deleted).

Because California's interest offset statute by its terms applies only to a corporation engaged in a unitary business whose income is subject to tax both in and out of California, its constitutionality cannot be properly analyzed in isolation. The California statute is part of a comprehensive tax scheme by which Hunt-Wesson's business income is apportioned among all of the states in which it conducts business pursuant to an apportionment formula which this Court has constitutionally approved. *Container Corp.*, 463 U.S. at 180-84. Just as the revenue derived from a unitary business is not confined to a single state, so too are the costs of production of that revenue unitary in nature. For this reason, the statute may be fairly evaluated by reference to this Court's jurisprudence relating to the unitary business principle and the formula apportionment of income.¹⁶

In *Container Corp.*, this Court upheld California's three-factor apportionment formula as a reasonable, albeit "necessarily imperfect," method of assigning income among the various components of a unitary business. *Id.* at 183. In doing so, this Court recognized that precise allocation of taxable items of corporate income among the various taxing jurisdictions in which a unitary business conducts its activities is "often an elusive goal, both in theory and in practice." *Id.* at 164. This Court has observed that "[a]llocating income among various taxing jurisdictions bears some resemblance . . . to slicing a shadow." *Id.* at 192. Accordingly, this Court has long refused to impose a single method of formula apportionment of income on the states. *Id.* at 164.

¹⁶ "A state tax must be assessed in light of its actual effect considered in conjunction with other provisions of the State's tax scheme." *Maryland v. Louisiana*, 451 U.S. 725, 756 (1981).

Instead, this Court has stated that the Constitution requires states only to be "fair" in applying an apportionment formula to determine how much of a corporation's income may be taxed. The fact that the precision by which income is apportioned to each state may be somewhat imperfect does not alone violate the Constitution. *Amerada Hess Corp. v. N. J. Taxation Div.*, 490 U.S. 66, 74 (1989). "The Constitution does not invalidat[e] an apportionment formula whenever it *may* result in taxation of some income that did not have its source in the taxing State." *Container Corp.*, 463 U.S. at 169-170 (internal quotation marks deleted).

Under formula apportionment, the fairness of a taxing provision is determined not by the effect of that provision on the amount of tax paid in one state, but on the amount of tax cumulatively paid in all states in which the corporation does business. If the amount of tax to which a multistate corporation is subjected approximates 100 percent of its tax base, fairness is achieved. *Id.* A "rough approximation" of a taxpayer's activities in the taxing state has been held sufficient in the formula apportionment of income from a unitary business. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978). Furthermore, only if the taxpayer can demonstrate by "clear and cogent evidence" that income attributed to a particular state is "out of all appropriate proportions to the business transacted . . . in that State" or has "led to a grossly distorted result" will this Court invalidate an apportionment formula. *Container Corp.*, 463 U.S. at 170.

The same considerations which led this Court to approve formula apportionment as a rational way to fairly assigning net income among various states are equally applicable to California's statutory formula for assigning interest expense to various classes of income. Both formula apportionment and California's allocation

formula were developed in response to the inherent difficulties of tracking income and expenses to their proper origin in a unitary business context. In the same way that income from a unitary business cannot be readily traced to a specific source, expenses incurred by a unitary business similarly cannot be readily traced to its ultimate application. Moreover, direct tracing of indebtedness to its ultimate use suffers from the same inherent weaknesses as formal geographical accounting in the context of formula apportionment: Both are subject to manipulation and precision and yield unreliable results. *See id.* at 164. Based on its previous discussion of these various issues, this Court's decisions in the area of formula apportionment provide a valid framework by which to evaluate California's formula for allocating interest expense.

C. California's interest offset statute satisfies this Court's "fairness" test of internal consistency

This Court declared in *Container Corp.* that the first component of fairness is whether the allocation formula has "internal consistency," such that if the apportionment formula was applied by every jurisdiction, it would result in no more than all of the unitary business' income being taxed. *Id.* at 169. The application of the "internal consistency" test does not depend on whether states other than the taxing state have in fact imposed a similar tax. *See Armco Inc.*, 467 U.S. at 644-45; *Tyler Pipe Industries v. Dept. of Revenue*, 483 U.S. 232, 247 (1987).

Subjecting California's interest offset statute to the same constitutional scrutiny which this Court applied to California's apportionment formula in *Container Corp.*, it is apparent that the manner by which the State allocates interest expense between business and nonbusiness income is constitutionally "fair." If every jurisdiction in

which Hunt-Wesson was taxable utilized an interest offset statute identical to California's, Hunt-Wesson would realize the full benefit of each dollar of interest expense which it incurred during the years in issue. To the extent that Hunt-Wesson's interest expense was attributed to its nonbusiness dividend income, thereby increasing its apportionable business income, the offset interest expense would be recognized and have the effect of reducing its tax liability in Illinois, its State of domicile.

D. California's interest offset statute satisfies this Court's "fairness" test of external consistency by providing a reasonable sense of how Hunt-Wesson's income was generated

This Court has also required a showing of "external consistency" as a component of fairness in the context of formula apportionment. *Container Corp.*, 463 U.S. at 169. External consistency requires that the factors used in the formula actually reflect a reasonable sense of how income is generated. *Id.* This test is also satisfied here.

As the California Supreme Court has recognized, interest expense bears a sufficient economic relationship to dividend income not taxable by California to justify the offsetting of one with the other. *Pacific Telephone*, 7 Cal.3d at 551-552, 498 P.2d at 1036. That relationship is based on the fungible nature of money and its potential for manipulation and substitution. The statute is premised on the belief that a corporation should not receive a full deduction for its interest costs when it invests in non-taxable activities with business funds which necessitated the borrowing in the first place. It aims to foreclose a state-subsidized tax advantage to a corporation over its competitors by equalizing the tax effect between a corporation that borrows money to enable it to earn non-taxable investment income and one which utilizes all of its funds

exclusively for business purposes without holding such investments.

Consider, for example, a corporation which, in the same year, (1) invests some of its available funds in a nonunitary subsidiary and (2) elects to incur debt to finance its business operations for that year. Inasmuch as the corporation could have reduced or even avoided the debt had it not tied up its funds in nonbusiness activities but instead used the funds to finance its business, it is highly questionable whether the company's business activities are truly the origin of the interest expense incurred. Thus, even where there is no direct or historical link between the purchase of nonbusiness assets and the loans on which interest expense is paid, it is reasonable to consider interest expense as the cost of obtaining interest and dividend income from nonbusiness securities regardless of the nominal purpose for which the money is borrowed.

Rather than allocating interest expense based on the value of business and nonbusiness assets, as some other states do, California takes a more direct, but equally rational, approach to "leveling the playing field" by eliminating a tax advantage to a corporation which incurs corporate debt when it has otherwise available funds of its own invested in securities and bonds. In this manner, the statute rationally and effectively ensures that a corporation that borrows money to enable it to earn nonbusiness income through investments will not pay less California tax than a corporation which owns no such investments but has incurred indebtedness to finance its business operations.

Hunt-Wesson itself impliedly concedes the existence of the relationship between interest expense and non-taxable dividend income by its citation to a variety of

"fair" and "presumptively constitutional" allocation methods which aim to assign interest expense by reference to nonbusiness activities. Pet. Br. at 28-32. Furthermore, the fact that each of these endorsed "reasonable" alternative methods utilizes a mechanical formula for assigning interest expense evinces Hunt-Wesson's tacit acknowledgement of the inherently fungible nature of money.

Hunt-Wesson's reliance on *Nat. Life Ins. Co. v. United States*, 277 U.S. 508 (1928) is inapposite. That case involved a deduction – measured by a percentage of an insurance company's "reserve funds required by law" reduced by the amount of interest income from tax-exempt securities – which was neither directly nor indirectly related to the receipt of tax-exempt interest income. Unlike an interest expense deduction from indebtedness which can be utilized with complete discretion, a deduction arising from an insurance reserve fund entails the use of money for a specific and limited purpose. Because financing the reserve fund was "required by law," it had no utility beyond the purpose of the fund itself. The funds contained in the reserve could not be manipulated, regardless of the origin of the money. Thus, once money was deposited into the reserve fund, the money lost its fungibility as well as any economic relationship to the tax-exempt income.¹⁷

¹⁷ To further illustrate, a corporation may elect to purchase an apartment building as an investment property. It may purchase the nonbusiness asset with either available cash or by incurring debt, which is subject to manipulation with respect to the allocation of interest expenses. However, once the apartment building is purchased, the depreciation is the same nonbusiness expense deduction regardless of the origin of the funds used to acquire it.

In contrast, Hunt-Wesson's decision to invest money in nonbusiness assets and the decision as to which funds to finance that investment were wholly discretionary. California's statute is premised on the economic reality that borrowed funds can be used for a variety of purposes and in a manner the ultimate disposition of which cannot be ascertained with ease. It is this potential for manipulation which distinguishes interest expense from other forms of deductions.

E. California's interest offset statute evenhandedly allocates interest expense between business and nonbusiness income

California's statute is furthermore constitutional because it assigns interest expense to business and nonbusiness income in an evenhanded and neutral manner. The statute does not require a corporation to demonstrate that interest expense is in fact attributable to the production of business income before it is allowed as a deduction. Similarly, California does not require a showing that interest expense which has been matched with nonbusiness income is in fact related to investment activities. In each instance, the statute reflects a legislative recognition that money is fungible and cannot be traced accurately to its ultimate use. Attempting to trace a corporation's source of funds and interest expense in every case would not only be administratively prohibitive but would lead to less than reliable or accurate results.

Accordingly, Hunt-Wesson's claim that "no portion of the proceeds of the loans . . . went *directly* to any non-unitary corporation" (emphasis added) during the years

in issue elevates form over substance.¹⁸ Pet. Br. at 5. The fact that the borrowed funds are not directly traceable to Hunt-Wesson's investment activities is neither constitutionally nor economically relevant. This is because, regardless of the ultimate use of the borrowed funds, the potential for manipulation inherent in money necessarily creates a rational connection between Hunt-Wesson's indebtedness and its nonbusiness income.¹⁹

Furthermore, if Hunt-Wesson had incurred debt for the sole purpose of making direct loans to its *nonbusiness* activities, the interest expense incurred from the indebtedness would be likewise subject to assignment under the interest offset statute. As a result, a portion of that interest expense would be available to reduce Hunt-Wesson's taxable *business* income. Given the fungible nature of money, such an allocation would be rational on the theory that the borrowed funds made available other

¹⁸ Hunt-Wesson's assertion implies, of course, that there may have been an *indirect* relationship between the loans and the foreign subsidiaries. Indeed, no evidence exists that Hunt-Wesson incurred the debt for the sole purpose of financing its business operations.

¹⁹ Thus, using Hunt-Wesson's example set forth at page 35 of the Brief for Petitioner, it is not economically significant that the proceeds of the loan from which interest expense was paid were used to purchase business manufacturing machinery rather than for nonbusiness purposes. Had the money which the corporation elected to invest in its dividend-producing nonbusiness subsidiary in Outer Mongolia been used instead to purchase the business machinery, there would have been no need for the loan on which interest expense was incurred to begin with. In any event, no evidence exists in this case as to the specific purpose for which the borrowed funds on which Hunt-Wesson incurred interest expense were in fact used.

existing funds for the corporation to apply to its business operations.

In fact, one might even contend that California "over-allocates" interest expense to *business* income. This is reflected in the ordering component of the statute which at the outset allocates interest expense to business income to the full extent of interest income from business activities. Thus, had the amount of Hunt-Wesson's business interest income during the years in issue equalled or exceeded its total interest expense, *all* of the interest expense would have been attributed to and deductible against its business income, regardless of the amount of nonbusiness dividend income generated. Furthermore, under the statute, California permits a deduction for any remaining interest expense in excess of nonbusiness interest and dividends, thus providing for an additional reduction of business income.

It is also important to note that the allocation of one dollar of Hunt-Wesson's total interest expense to non-business income does not result in a one dollar increase in its income subject to California tax. As a multistate corporation engaged in a unitary business, Hunt-Wesson's net business income is apportioned among all states in which it engages in business. As a result, an interest offset of one dollar to nonbusiness income will result in only an *apportioned* increase in California taxable income. For example, if only 15 percent of Hunt-Wesson's net business income is apportioned to California under its apportionment formula, then an interest offset of one dollar against nonbusiness income would result in only a 15 cent increase in business income apportioned to California.

F. The states should not be constitutionally compelled to adopt a uniform method of allocating interest expense to the exclusion of other methods

Hunt-Wesson seeks to have this Court "constitutionalize" the manner by which states are permitted to allocate interest expense deductions between taxable and non-taxable income. Hunt-Wesson alleges that other taxing jurisdictions utilize "fair" and "reasonable" statutory and regulatory allocation formulas by relating interest expense to non-taxable activities in a manner which differs from California's approach. For this reason, Hunt-Wesson suggests, the California statute must be unconstitutional. Hunt-Wesson's position is spurious.

First, in the analogous context of formula apportionment, this Court has refrained from *requiring* states to adopt a uniform apportionment formula under the Constitution. *Container Corp.*, 463 U.S. at 171; *Moorman Mfg. Co. v. Bair*, 437 U.S. at 278-80. "[A] fairly apportioned tax [will] not be found invalid simply because it differed from the prevailing approach adopted by the States." *Container Corp.*, 463 U.S. at 171. Similarly, nothing in the Constitution *requires* all states to uniformly follow a particular formula for assigning interest expense. Whether or not an allocation formula exists elsewhere which is arguably "better" or "fairer" than California's statute is not constitutionally significant. It is for each state's legislature to determine whether to follow or diverge from the prevailing approach followed by other states. California's approach must be therefore evaluated on its own merits.

Second, Hunt-Wesson fails to provide any explanation as to how or why any of the alternative methods which it has embraced more "fairly" or "rationally" allocate interest costs to classes of income. Nor has Hunt-Wesson offered any proof to this Court that it would have

been entitled to deduct more interest expense from its business income under any of these alternative formulas.

Third, it is at least debatable whether any of the alternative allocation methods truly differ in substance from California's approach. Similar to the California statute, these methods assign interest expense to business income by a formula which takes into account nonbusiness activities.²⁰ The allocation formulas furthermore recognize (1) the fungible nature of money, and (2) the economic relationship between a corporation's interest expense and its level of non-taxable activity. The precision by which these methods relate interest expense to business and nonbusiness activities may also be subject to criticism.²¹ However, if nothing else, Hunt-Wesson's high

²⁰ Hunt-Wesson's reliance on the administrative decision of the California State Board of Equalization ("SBE") in *Appeal of Zenith Nat'l Ins. Corp.*, 1998 Cal. Tax LEXIS 1, 4 Cal. St. Tax Rep. (CCH) ¶ 402-965 is unavailing. First, the SBE's decision did not involve an interpretation of Cal. Rev. & Tax. Code § 24344, but rather Cal. Rev. & Tax. Code § 24425. Second, the SBE acknowledged that the Board's argument that interest expense is not susceptible to direct tracing because of the fungible nature of money was "valid." Third, although the SBE, over the Board's objections, interpreted section 24425 as authorizing direct tracing, it did so only on the basis of similar language contained in section 265 of the Internal Revenue Code. I.R.C. § 265. Finally, nothing in section 24425 itself suggests that the California Legislature intended to incorporate direct tracing as a means of implementing the terms of the statute. Nor has the Legislature seen fit to modify section 24344 in response to *Zenith*.

²¹ For instance, the assignment of interest expense on the basis of the value of nonbusiness assets is potentially problematic. Under this method, the amount of interest expense attributed to nonbusiness activities increases as the value of the investment asset increases, even though the amount of funds used to purchase the asset is unchanged. There also exist difficulties in determining the value of those assets. It is

regard for these "rational" alternative allocation formulas may be fairly viewed as an implied acknowledgement that an interest expense deduction which is determined by reference to non-taxable investment activities does *not* necessarily amount to the taxation of non-taxable income.

Finally, Hunt-Wesson's endorsement of these alternative formulas is less than candid. It does not ask this Court to permit it to recalculate its interest expense deduction by any one of the alternative "fair" allocation methods which it embraces. Nor does it contend that, to the extent that some of the alternative provisions permit direct tracing, it is capable of tracing every dollar of debt which it incurred during the years in issue to business-related activities. Rather, it seeks the best of both worlds – not only to have this Court invalidate California's statute but to also reduce its California business income by the *full* amount of its interest costs without any allocation or any showing that they were in fact attributable to the production of business income. It continues to maintain, without hint of compromise, that none of the more than \$273 million in interest expense incurred during the years in issue was in any way related to the approximately \$75 million of nonbusiness dividends which its investments generated.

administratively impractical to base an asset's value on fair market value because of the need for appraisals, sometimes for assets located around the world, in order to obtain the most accurate measure of interest expense. On the other hand, the valuation of assets by the measure of depreciated basis may be significantly lower than the valuation based on fair market value.

G. No indirect tax on non-taxable income results from California's inclusion of Hunt-Wesson's nonbusiness dividend income in the allocation of Hunt-Wesson's interest expense under the interest offset statute

Hunt-Wesson contends that California's statute indirectly taxes a corporation's nonbusiness income which is immune from taxation.²² This claim must be rejected.

First, California does not seek to tax, either directly or indirectly, Hunt-Wesson's nonbusiness income. Rather, California seeks to tax only its share of Hunt-Wesson's business income, as measured by the deduction of only that portion of interest expense which is attributable to the production of business income. The California Legislature's interest in taxing only business income is reflected in the statute's ordering rule, which at the outset allocates a corporation's interest expense to business income to the full extent of its business interest income, regardless of the amount of its nonbusiness income. Thus, a foreign corporation which has no California business income, but receives only non-taxable nonbusiness income during a taxable year, will incur no California tax liability, regardless of the amount of interest expense which would be allocated to nonbusiness income under the statute. Hunt-Wesson's objection thus boils down to little more than an attack on the amount of tax which California has imposed on its business income, which the State is indisputedly permitted to tax.

²² The record contains no evidence that the dividends in question were actually taxed in full as nonbusiness income in Hunt-Wesson's state of domicile. Moreover, no evidence exists that Hunt-Wesson even reported the dividends as business income in its state of domicile.

Second, as the California Supreme Court correctly concluded in *Pacific Telephone*, the inclusion of non-taxable dividends in the interest offset calculation is not tantamount to the indirect taxation of such dividends. *Pacific Telephone*, 7 Cal.3d at 555, 498 P.2d at 1038.²³ The mere fact that the interest expense deduction against business income is reduced by the amount of the interest offset does not mean that non-taxable income is being taxed. If consideration of a corporation's nonbusiness activities in calculating the amount of business income subject to state tax means that its nonbusiness income is being taxed, then practically all interest expense allocation methods would be vulnerable to constitutional challenge. This would include the "presumptively constitutional" allocation methods identified by Hunt-Wesson which assign interest expense to related income by reference to the ratio of nonbusiness income to total income as well as by reference to the ratio of the value of nonbusiness assets to total assets. Pet. Br. at 28-32. A statute that simply matches expenses with taxable income by reference to non-taxable income does not convert the statute into an unconstitutional tax on non-taxable income.

Third, although it is literally true that the reduction of Hunt-Wesson's California interest expense deduction was "due entirely" to its nonbusiness dividends, it is *not* true that Hunt-Wesson's interest expense and dividend income are unrelated. The statute matches interest expense with classes of income in such a manner that, by necessity, will increase Hunt-Wesson's apportionable

²³ See *Barclays Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298, 312 n. 10 (1994) (approximating California income through formula apportionment by reference to non-California income does not constitute taxation of non-taxable income).

business income because it could not reduce its business income by the full amount of its interest expense. However, this is simply the result of charging non-taxable income with its fair share of burdens. A corporation which borrows money to finance its business operations when it simultaneously has its own funds invested in non-taxable securities is not constitutionally entitled to pay less tax than a corporation without such investments. Conversely, due process does not require a corporation that holds no non-taxable investments to bear a heavier tax burden than one that does hold such investments.

Fourth, although the Constitution protects Hunt-Wesson's nonbusiness dividend income from the burden of taxation in California, it does not afford to it an entitlement to deductions stemming from expenses attributable to such income. Hunt-Wesson cannot be allowed to complain that it has not been made the full recipient of more favorable tax treatment which the California Legislature has not authorized and which this Court is not constitutionally mandated to give.

During the years in issue, California's interest offset statute had been already in existence for over 20 years. Hunt-Wesson was well-aware of its operation and was free to choose the manner by which to structure its financial affairs. Once having done so, it is bound by the tax consequences of that choice, whether intended or not, and may not benefit from some other path which it might have chosen to follow but did not. *See Commissioner v. Nat. Alfalfa Dehydrating*, 417 U.S. 134, 148-49 (1974).

In the final analysis, California's statute attempts to do nothing more than assign expenses between taxable income and non-taxable income in order to determine the extent to which a deduction should be allowed against business income which the State is entitled to tax. While Hunt-Wesson is constitutionally entitled to protection

from the taxation of non-taxable income, California is just as entitled to protect itself from unfair tax avoidance. California's statute does nothing more than require Hunt-Wesson to pay its own way. As such, it is fully consistent with due process.

II.

CALIFORNIA'S INTEREST OFFSET STATUTE DOES NOT FACIALLY DISCRIMINATE AGAINST INTER-STATE COMMERCE ON THE BASIS OF DOMICILE

Hunt-Wesson contends that California's interest offset statute violates the Commerce Clause because it facially "discriminates against nondomiciliary corporations in favor of domiciliary corporations" in that the "allowance or disallowance of the [interest expense] deduction turns entirely on the domicile of the dividend-receiving corporation." Pet. Br. at 33 & 37. Hunt-Wesson's claim is meritless.

A facial challenge to a statute requires a showing by the claimant that the statute could not be constitutional under any existing circumstances.²⁴ *United States v. Salerno*, 481 U.S. 739, 745 (1987). Hunt-Wesson has failed to meet its heavy burden of proving discrimination.

²⁴ In most of this Court's recent cases striking down statutes because they facially discriminated against interstate commerce, the legislature that enacted the offending statute can fairly be said to have had a discriminatory intent. In contrast, Hunt-Wesson does not contend in its Brief for Petitioner that the statute before this Court reflects a discriminatory intent on the part of the California Legislature. Although a letter from former California Governor Knight, prior to the signing of the legislation enacting the statute, describes the likely consequence of the statute, Hunt-Wesson has not pointed to any legislative intent to discriminate against foreign corporations. *Pacific Telephone*, 7 Cal.3d at 554, 498 P.2d at 1038.

California's statute, whether viewed as a collection of parts or as a totality, is facially neutral. Nothing in the language of the statute compels the assignment of interest expense on the basis of domicile.²⁵ The statutory ordering rule is applied in the same manner and with equal force to both domestic and foreign corporations.

Discrimination, for constitutional purposes, is prohibited only as to taxpayers which are similarly situated. See *General Motors Corp. v. Tracy*, 519 U.S. 278 (1997). In order to prove discrimination, Hunt-Wesson must identify an appropriate comparison class of the most similarly situated taxpayers and demonstrate that the tax treats the members of one class more favorably than the other.

Hunt-Wesson claims that the basis for discrimination lies between domestic and foreign corporations. In reality, the constitutionally relevant basis for comparison is between corporations that operate on borrowed money while simultaneously holding investments which generate income exempt from California tax and corporations that do not hold such investments and devote their entire capital to their business operations, thereby reducing or eliminating the need to incur debt.

The so-called discriminating treatment is not tied to domicile, but in fact to the character of income to which interest expense is assigned. The statute aims to ensure that a corporation that invests in nonbusiness activities while operating on borrowed funds and a corporation that operates on its own capital without such investments are similarly situated for state tax purposes. In this manner, the assignment of interest expense to business

²⁵ As previously noted, it is not universally true that domicile is the operative component in California in determining where nonbusiness income is taxable. See Cal. Rev. & Tax. Code, §§ 25123-25127.

income does not discriminate against non-domiciled corporations – the amount assigned to nonbusiness income is the same regardless of where the corporation is domiciled – but simply places the two corporations on the same footing.

The fact that the character of Hunt-Wesson's income and not its domicile is the controlling component of the statute can be readily illustrated. If, for example, Hunt-Wesson had received no investment interest or dividend income during the years in issue, *all* of the interest expense would have been available to reduce its apportionable business income regardless of where it is domiciled. Similarly, if Hunt-Wesson's interest expense during the years in issue had equalled or not exceeded its business interest income, the entire amount of interest expense would have been available under the statute to reduce its apportionable business income. This would have been so even though Hunt-Wesson is domiciled outside of California.

Discrimination is not established simply because there may exist some geographical implications to the application of California's statute. The chance that the assignment of interest expense to classes of income taxable outside the State may work to the disadvantage of corporations not domiciled in California is, as Hunt-Wesson itself acknowledges, "nothing more than a description of the natural consequences of allowing an interest expense deduction that corresponds to the State's power to tax nondomiciliary and domiciliary taxpayers' income." Pet. Br. at 34.

When viewed in the context of income apportionment, the flaw in Hunt-Wesson's claim that the California statute favors domestic corporations over foreign corporations is even more evident. California's matching of a corporation's interest expense with nonbusiness income

taxable in its state of domicile does not deprive the corporation of the full benefit of that expense in reducing its overall worldwide tax liability. Rather, consistent with unitary principles, the California statute simply assigns interest expense to business and nonbusiness income, so as to more accurately reflect the origin of that expense. As a result, to the extent that the assignment of interest expense to nonbusiness income, which is itself allocated to the corporation's domicile, leads to an increase in income subject to tax by California, a corresponding decrease in taxable income occurs in the state of domicile. In this manner, California neither imports revenue nor exports burdens to other states in violation of interstate commerce.

This Court has held that income which is fairly apportioned to a taxpayer's activities in the state eliminates the risk that it will subject interstate commerce to a multiple tax burden not borne by local commerce. The anti-discrimination principle of the Commerce Clause "has not in practice required much in addition to the requirement of fair apportionment." *Container Corp.*, 463 U.S. at 171.

This Court has also interpreted the Commerce Clause to require a tax statute to have "internal consistency." *Armco Inc.*, 467 U.S. at 644; *Container Corp.*, 463 U.S. at 169. The internal consistency principle implements the view that the Commerce Clause forbids taxes that penalize taxpayers merely because they do business across state lines. Whether internal consistency exists does not depend on whether states other than the taxing state have in fact imposed a similar tax. *Tyler Pipe Inds. v. Dept. of Revenue*, 483 U.S. at 247; *American Trucking Assns. v. Scheiner*, 483 U.S. 266, 282-84 (1987).

Here, as previously noted, California's statute passes the "internal consistency" test. If every state in which

Hunt-Wesson was taxable utilized a statute identical to California's interest offset statute, Hunt-Wesson would realize the full benefit of each dollar of interest expense which it had incurred. Any decrease in Hunt-Wesson's interest expense allocable to California as a result of the assignment of interest expense to nonbusiness dividend income would result in a corresponding increase in its interest expense allocable to Illinois, its State of domicile. In this manner, Hunt-Wesson would not bear any burdens greater than its domestic counterpart.

The fact that the State of Illinois does not have a statute identical to California's interest offset statute does not invalidate the internal consistency test. The constitutionality of a tax statute does not "depend on the shifting complexities of the tax codes of 49 other States" and "the validity of the taxes imposed on each taxpayer [does not] depend on the particular other States in which it operated." *Armco Inc.*, 467 U.S. at 645. It is undesirable, as a matter of principle, to create a rule a law that depends for its operation on the present configuration of statutes of other states.²⁶

Moreover, the extent to which Hunt-Wesson is adversely affected in California is not attributable to any defects inherent in the statute. California applies the statute equally to both California corporations and non-California corporations doing business in the State. Any disparity results from the combined effect of the California statute and the absence of an identical statute in Hunt-Wesson's state of domicile. Yet, California cannot, and should not, be held accountable for the latter.

²⁶ Such a rule of law would also be disfavored as a matter of practice. Not only would states encounter compliance and administrative difficulties in tax collection, taxpayers would also face uncertainties in determining their state tax liabilities.

In the final analysis, Hunt-Wesson's characterization of the effect of California's statute as "discriminatory" is nothing more than a way of describing the consequences of the absence of uniformity between California and Illinois tax laws. Such consequences could be readily eliminated if Illinois adopted a statute identical to California's. However, on its own terms, California's statute is not inherently discriminatory.

III.

IN THE PARENTHETICAL PROVISIONS OF CALIFORNIA'S INTEREST OFFSET STATUTE, DIVIDENDS DECLARED FROM INCOME ALREADY INCLUDED IN THE MEASURE OF CALIFORNIA'S TAX ARE UNIFORMLY EXCLUDED FROM THE INTEREST OFFSET FORMULA

Turning away from the principal components of California's interest offset statute, Hunt-Wesson lastly complains about the parenthetical provisions of the allocation formula. In doing so, Hunt-Wesson seeks to draw this Court into an unnecessary constitutional discussion of a separate and complex statute, one which is currently under challenge in the California courts.²⁷

Under California's interest offset statute, once interest expense is assigned to apportionable business income to the extent of business interest income, any remaining interest expense is deductible against apportionable business income to the extent that interest expense exceeds nonbusiness interest and dividend income. However, the statute parenthetically excludes from this calculation all "dividends deductible under the provisions of Section 24402." Dividends deductible under section 24402 of the

²⁷ *First Credit Bank & Subsidiary v. Franchise Tax Board*, Los Angeles County Superior Court, No. BC205481.

California Revenue and Taxation Code consist of dividends "declared from income which has been included in the measure of" the California tax of the dividend declarant.

Hunt-Wesson contends that California's interest offset statute is discriminatory because it impermissibly favors in-state over out-of-state investment by affording a foreign corporation a greater deduction of interest expense against business income "to the extent that the dividends [are derived] from corporations that are taxable in California." Pet. Br. at 38. This contention lacks merit.

First, Hunt-Wesson's claim must be rejected at the outset because it has failed to identify the proper comparison classes by which to evaluate its claim of facial discrimination. Hunt-Wesson attempts to distinguish between foreign corporations that invest in companies whose earnings are derived from out-of-state activities and foreign corporations that invest in companies whose earnings are derived from in-state activities. Yet, as between these two classes of corporations, California's interest offset statute is applied in exactly the same manner and to the same extent - in each instance, all dividends declared from income already subjected to California tax are excluded from the interest offset computation.

In reality, Hunt-Wesson's complaint is not with the interest offset statute at all, but rather with the fact that the amount of excluded dividends as determined by section 24402 may vary according to the level of in-state activity of the dividend payor. However, this occurrence results not from the operation of the interest offset provision, but rather from the operation of section 24402 itself. Any finding in favor of Hunt-Wesson on this question

would necessitate a determination that section 24402 itself is unconstitutional.

Because Hunt-Wesson's complaint is in truth little more than a disguised attack on the constitutionality of section 24402 itself, this Court is not compelled to address it in this case. It is questionable whether the constitutionality of section 24402 is properly present in this litigation. Hunt-Wesson has not expressly challenged the constitutionality of section 24402 in its complaint. J.A. 4-11. The sole basis for Hunt-Wesson's complaint is the constitutionality of section 24344 of the California Revenue and Taxation Code. Furthermore, Hunt-Wesson does not allege anywhere in its Brief for Petitioner that section 24402 itself is unconstitutional.

Second, even if Hunt-Wesson is permitted to contest the constitutionality of section 24402, its challenge must fail. In *Fulton Corp. v. Faulkner*, 516 U.S. 325, on which Hunt-Wesson relies, the North Carolina intangibles tax on the value of stock held by North Carolina resident shareholders was struck down as facially discriminatory. In so holding, this Court ruled that the tax could not be upheld as compensatory to the general corporate income tax imposed on the issuing corporation doing business in the State. No burden on intrastate commerce could be identified for which the intangibles tax allegedly compensated. Any comparison between the size of the intangibles tax and the general corporate income tax was impossible because the two taxes were based on different events. Furthermore, the two taxes failed to fall on the same class of taxpayers.

In contrast, the deduction of dividends under section 24402 is intended "to avoid double taxation at the corporate level of income which has already been subjected to California taxation in the hands of the dividend-declaring corporation." *Pacific Telephone*, 7 Cal.3d at 548 n. 4, 498

P.2d at 1034 n. 4. As the California Court of Appeal found in rejecting Hunt-Wesson's claim, because California had already taxed the dividends in question, no unconstitutional discrimination results from the State's efforts to refrain from double taxation. J.A. 64. Thus, no advantage is afforded to California subsidiaries over foreign subsidiaries. The exemption does nothing more than compensate for the earlier taxation of the dividend-producing income by California, thereby eliminating the chance that such income might be subjected to taxation more than once.²⁸

By limiting the amount of the dividend-received deduction to the amount of the subsidiary's earnings that have already been subject to California tax, section 24402 has the effect of equalizing the cost on interstate commerce and intrastate commerce. Whether the corporate payor's earnings which generated the dividends are taxed as income by California to the payor or result in a denial of a dividend deduction to Hunt-Wesson, the income is in either case subject to California tax at the same rate. Conversely, under section 24402, if none of the dividends is permitted as a deduction to the payee, none of the payor's earnings is subject to taxation by California. The net effect is thus the same, regardless of whether

²⁸ The exclusion of section 24402 dividends from the interest offset calculation reflects the fact that interest expense relating to the production of exempt dividends is denied separately as a deduction by virtue of Cal. Rev. & Tax. Code, § 24425, which proscribes the deduction of any expense allocable to income not taxable by California. See *Great Western Financial Corp. v. Franchise Tax Bd.*, 4 Cal.3d 1, 479 P.2d 993 (1971). For this reason, the amount of a corporation's interest expense which is attributable to such non-taxable income, as measured by the section 24402 dividends, is properly not taken into account for purposes of the interest offset statute.

the dividends are paid by a corporation doing business in California. As a result, the overall effect on interstate commerce is roughly equivalent to the tax on intrastate commerce. Corporations that engage in business in California thus are afforded no greater advantage over their foreign counterparts.²⁹

Furthermore, even within the context of California's interest offset statute, California's assignment of a foreign

²⁹ At worst, section 24402 regulates evenhandedly with only negligible impact on interstate commerce. See *Oregon Waste Systems, Inc. v. Department of Environmental Quality of Ore.*, 511 U.S. 93, 99 (1994). Nondiscriminatory tax statutes which have only incidental effects on commerce are valid unless " 'the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.' " *Id.* No excessive burdens are present here. As noted above, the statute serves the legitimate local purpose of preventing double taxation of the same income by California. Since dividends received from a corporation which is not subject to tax in California is taxed only once, no deduction is necessary with respect to those dividends. As a matter of policy, California's practice of allowing a deduction only where it will alleviate double taxation by a taxing jurisdiction is utterly reasonable.

Furthermore, the legitimate local purpose advanced under section 24402 "cannot be adequately served by reasonable nondiscriminatory alternatives." *Id.* at 101. Without permitting a dividend-received deduction in proportion to the amount of business conducted by the payor corporation in California, the dividend would be subject to taxation twice by California. Conversely, permitting a full 100 percent dividend-received deduction without limitation, as Hunt-Wesson appears to favor, would have the unfair and inadequate result of permitting corporations doing business in California to escape taxation altogether for dividend income which the State is entitled to tax. California has the constitutional right to tax income derived from sources within the State. To permit an unlimited dividend-received deduction would create a tax loophole through which a California corporation could avoid significant State taxation.

corporation's interest expense to nonbusiness income does not necessarily result in the irretrievable loss of a tax deduction. Because California's interest offset statute is internally consistent such that if all states in which a corporation is taxable adopted a statute identical to California's, the corporation's taxable income in the state of domicile would decrease in proportion to the amount that its taxable income in California would increase.

In *Fulton*, the tax liability imposed on North Carolina corporate stockholders was not determined within the context of an allocation of tax burdens among the states. Here there is such an allocation. Under California's interest offset statute, the level of in-state activity does not affect a corporation's overall tax liability, but affects merely the extent to which interest expense is allocated between sources in and out of California. The corporation's overall tax liability from its worldwide income remains unchanged because whatever interest expense is allocated to nonbusiness income is not lost to the corporation: it is simply shifted to the state where the nonbusiness income is subject to tax.

Thus, to the extent that the out-of-state activity of a corporation's nonunitary subsidiary results in an increase in the amount of interest expense assigned to nonbusiness income, a commensurate amount of interest expense becomes available to offset taxable income in the state of its domicile. As a result, the California statute imposes no greater burden on interstate commerce than intrastate commerce. It is this fundamental difference between North Carolina's intangible property tax and California's interest offset statute which renders *Fulton* inapplicable to this case.

In summary, should this Court conclude that a consideration of section 24402, a statute both separate and

severable from California's interest offset statute, is warranted in this case, Hunt-Wesson's claim must fail. California provides no incentive to foreign corporations to invest in companies that engage in business only in the State. Conversely, no penalty accrues from a foreign corporation's election to invest in a subsidiary engaged in activities outside of California. In either case, the overall tax liability to the corporation remains the same, regardless of the level of in-state activity by the dividend-paying subsidiary.

CONCLUSION

For all of the foregoing reasons, the judgment of the California Court of Appeal should be affirmed.

Respectfully submitted,

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APPENDIX

Application of California's Interest Offset Statute to Hunt-Wesson

	1980	1981	1982	TOTAL
Total Interest Expense	80,490,469	55,101,503	137,413,162	273,005,134
Less: Unitary Business Interest Income (A)	10,217,578	21,389,332	83,920,105	115,527,015
Balance (B)	70,272,891	33,712,171	53,493,057	157,478,119
Less: Nonbusiness Dividend Income (C)	26,718,620	29,482,367	19,022,617	75,223,604
Balance (D) (B minus C)	43,554,271	4,229,804	34,470,440	82,254,515
Total Interest Expense Subject to Apportionment in California (A plus D)	53,771,849	25,619,136	118,390,545	197,781,530
Interest Offset (Lesser of B or C)	26,718,620	29,482,367	19,022,617	75,223,604

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No. 98-2043

FILED

DEC 29 1999

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SUPREME COURT, U.S.

In The
Supreme Court of the United States

— ♦ —
HUNT-WESSON, INC.,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

— ♦ —
**On Writ Of Certiorari To The
Court Of Appeal Of California
For The First Appellate District**
— ♦ —

REPLY BRIEF FOR PETITIONER
— ♦ —

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RULE 29.6 STATEMENT

Hunt-Wesson, Inc. is a wholly owned subsidiary of ConAgra, Inc. Its non-wholly-owned subsidiaries are ConAgra Brands, Inc. and ConAgra Limited.

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REPLY BRIEF FOR PETITIONER

Petitioner identified two, independent mechanisms by which Cal. Rev. & Tax. Code § 24344 denied it an interest deduction in violation of the Constitution: first, the statute denied petitioner an interest deduction merely because petitioner received nontaxable dividends;¹ second, the statute denied petitioner an interest deduction because those dividends were paid by subsidiaries that did no business in California. If either of these mechanisms is constitutionally infirm, petitioner is entitled to the interest deduction at issue.

Respondent's defense of the first mechanism California employs to deny petitioner an interest expense deduction – reducing its interest expense by the amount of its nontaxable dividends – is unpersuasive. The underlying theme of respondent's defense is that the interest offset is simply part of a "fair" and "rational" method for "matching" expense to income and that its constitutionality should be judged by the loose standards that this Court applies to the constitutionality of apportioned income taxes. But this defense simply ignores the undisputed facts and controlling law of this case.

First, the interest-offset provision cannot seriously be characterized as a "fair" and "rational" method for "matching" expense to income. Rather than "matching" expense to income, the interest-offset provision arbitrarily assigns a dollar of interest expense to a dollar of nontaxable income regardless of the relationship of the expense to the nontaxable income. As a consequence, the interest-offset provision will invariably attribute interest expense to nontaxable income in a different way than it attributes interest expense to taxable income. This is not "fair"; this is not "rational"; and it is not "matching."

¹ Petitioner contended that this mechanism (1) taxes income beyond California's reach in violation of the Due Process and Commerce Clauses (Brief for Petitioner ("Pet. Br.") 18-33) and (2) discriminates against nondomiciliary corporations in violation of the Commerce Clause. *Id.* at 33-37.

Second, even assuming that "money is fungible" (Brief for Respondent ("Resp. Br.") *passim*) and that interest expense cannot be traced to particular items of income, it does not follow that any allocation of interest expense – no matter how arbitrary – can pass constitutional muster. If interest expense "cannot be reliably traced to its ultimate use," *id.* at 21, then interest expense may be allocated to a taxpayer's income by any of a variety of reasonable methods – such as those widely adopted by States other than California – which allocate interest expense between taxable and nontaxable income on a nondiscriminatory basis. What a State may not do – and what California has done here – is systematically to assign interest expense to income that the State may not constitutionally tax.

Third, there is no merit to respondent's contention that all of this is constitutionally tolerable because the interest offset's constitutionality should be determined under the relaxed standards this Court has applied to constitutional challenges to formulary apportionment of income. Under respondent's theory, any provision of a state's apportioned corporate income tax, no matter how offensive to constitutional norms when viewed by itself, is invulnerable to attack as long as the resulting apportionment does not produce a "grossly distorted result." *Id.* at 25. That is not the law. *See, e.g., Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388 (1984).

Respondent has made no serious effort to defend the second mechanism by which it denies petitioner an interest deduction – confining petitioner's interest expense deduction by reference to the in-state activities of its dividend-paying subsidiaries. Respondent does not even advert to this issue in its summary of argument, and, when it turns to the question at the tail end of its brief, respondent makes the ludicrous suggestion that "this Court is not compelled to address it" (Resp. Br. 46) because the constitutional flaw that petitioner has attacked can be traced to a more fundamental defect in California's taxing scheme.

On the merits, respondent's perfunctory defense of California's preference for investment in in-state over out-of-state

corporations is so weak and confusing that one understands why respondent has done its best to bury the issue. In its futile effort to distinguish *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), which invalidated a virtually identical in-state preference scheme, respondent claims that California's in-state preference may be justified by its benign purpose – the avoidance of double taxation. But this contention runs headlong into settled Commerce Clause doctrine that States may not pursue even legitimate objectives by discriminatory means. Respondent's further suggestion that the goal of avoiding double taxation "cannot be adequately served by reasonable nondiscriminatory alternatives" (Resp. Br. 48 n.29) not only concedes the essential point that the statute *is* discriminatory, but also ignores the fact that there is a readily available nondiscriminatory alternative – treating all dividends the same. And respondent's argument, repeated throughout its brief, that the interest-offset provision is constitutional because it is "internally consistent" rests on a non sequitur: While it is true that statutes that are *not* "internally consistent" are *not* constitutional, it does not follow that statutes that *are* "internally consistent" *are* constitutional. *See, e.g., New Energy Co. v. Limbach*, 486 U.S. 269 (1988) (striking down "internally consistent" reciprocity statute that discriminated against interstate commerce).

I. THE INTEREST-OFFSET PROVISION'S ARBITRARY ASSIGNMENT OF PETITIONER'S INTEREST EXPENSE TO ITS NONTAXABLE INCOME INDIRECTLY TAXES SUCH INCOME, EVEN IF ONE ACCEPTS RESPONDENT'S ERRONEOUS DESCRIPTION OF HOW THE INTEREST-OFFSET PROVISION OPERATES

A. The Interest-Offset Provision Applies Only to Business Interest Expense, and This Court Should Disregard Respondent's Eleventh-Hour Attempt to Repudiate Its Own Stipulation

The parties stipulated that "nonbusiness interest expense . . . was deducted from total interest expense" before the interest-offset computation was made and that only "business

interest expense" was "subject to the 'interest offset' computation." Stip. ¶ 11 (Joint Appendix ("J.A.") 20). Respondent now seeks to repudiate this stipulation. It contends that it never stipulated "that the elimination of nonbusiness interest expense is a *statutory* component of the interest offset computation." Resp. Br. 19-20 n.13 (emphasis supplied). Instead, it argues, the stipulation is based only on respondent's own form, which, respondent now tells us, "*erroneously* instructs the taxpayer to identify and subtract its nonbusiness interest expense" prior to the application of the interest-offset provision. *Id.* (emphasis supplied). Respondent then informs this Court that, nearly two decades after the years at issue when the form in use purportedly did "not correctly implement the provisions of the statute," respondent is "empowered retroactively to correct mistakes of law" that it made in issuing "the form in use during the years in issue." *Id.*

Respondent's eleventh-hour disavowal of its own stipulation is a transparent attempt to revise the facts of this case to its own liking. There is no foundation for respondent's revisionist view of the operation of the interest-offset provision,² and the provision's arbitrary operation is exacerbated by the exclusion from its scope of interest expense that is directly traceable to nonbusiness income. Nevertheless, petitioner agrees with respondent that, on the facts of this case, the

² Indeed, respondent's claim, contrary to its stipulation, that the interest-offset "statute is applied to *all* 'interest' expense" (Resp. Br. 5 (emphasis supplied)) and not just to "business interest expense" is belied by respondent's own assertion, in a later section of its brief, that "interest expense relating to the production of exempt dividends is denied separately as a deduction by virtue of Cal. Rev. & Tax. Code § 24425, which proscribes the deduction of any expense allocable to income not taxable by California." *Id.* at 47 n.28; *see also* Brief Amicus Curiae of Idaho, et al. 27. This is the very provision that constitutes the statutory basis for what respondent now claims are the "erroneous" instructions contained in the tax forms in use during the years at issue. Respondent has failed to explain how Cal. Rev. & Tax. Code § 24425 provides the statutory basis for allocating interest expense to one class of exempt dividends but not to another.

"confusion" respondent has admittedly created "is not constitutionally significant." *Id.* at 19-20 n.13.³ The fundamental flaw in the statute – the arbitrary assignment of interest expense to nontaxable income without regard to the relationship between the expense and the income – remains regardless of whether there is any preliminary allocation of nonbusiness interest expense to nonbusiness income.

B. The Undisputed Facts Reveal That There Is No Matching of Interest Expense to Nontaxable Income and That Interest Expense Is Assigned Disproportionately to Nontaxable Income

Respondent's case rests on the premise that the interest-offset provision constitutes a "fair" and "rational" method for "matching" interest expense to exempt income. That premise is demonstrably false. During the years at issue California assigned one dollar of interest expense to each dollar of nonunitary dividend income that lay beyond its taxing power, but less than thirteen cents of interest expense to each dollar of unitary income that it could tax. *See* Appendix B.⁴

³ In light of respondent's position that it "is not constitutionally significant" whether directly traceable nonbusiness interest is excluded from the interest offset computation, it is rather astonishing that the Multistate Tax Commission ("MTC") devotes a substantial portion of its amicus brief to this issue. Even more astonishing is the fact that the MTC's position in its amicus brief is contradicted by its own audit manual, which clearly states that in California nonbusiness interest expense is subtracted from total interest expense *before* computation of the interest offset. *See* MTC Corporate Income Tax Audit Procedure Guideline Manual, MTC Schedule 1205 (reproduced at App. 1a).

⁴ In Appendix B to this brief (lines 9-10), we set forth the calculations, based on the undisputed facts of this case, that demonstrate the following: For 1980, the interest-offset provision assigned \$1.00 of interest expense to each \$1.00 of nontaxable dividends, but only \$0.11 of interest expense to each \$1.00 of taxable business income; for 1981, the respective figures were \$1.00 and \$0.05; and for 1982, the respective figures were \$1.00 and \$0.21. For all three years, the interest-offset provision assigned \$1.00 of interest expense to each \$1.00 of nontaxable

Nowhere does California explain why it takes one dollar of interest expense to finance the production of one dollar of income that it cannot tax but only thirteen cents of interest expense to finance the production of one dollar of income that it can tax. By what form of alchemy does borrowed money miraculously become more productive when it is used to generate taxable rather than nontaxable income? Whatever California is doing, one thing is for sure: it is not "matching" interest expense to interest income. Rather, it is arbitrarily and mechanically assigning it disproportionately to nontaxable income.

C. Respondent's Assumption That "Money Is Fungible" and That Interest Expense Cannot Be Traced to Particular Items of Income Does Not Justify an Interest Allocation Methodology That Assigns Income Disproportionately to Nontaxable Income

Respondent repeatedly asserts that "California's interest offset statute is based on the rationale that money is fungible and cannot reliably be traced to its ultimate use." Resp. Br. 21; *see also id. passim*. But this proposition does not justify the interest-offset mechanism. Even if we accept the notion that "money is fungible and cannot be traced accurately to its ultimate use," *id.* at 30, it does not follow that any methodology for assigning interest expense – even one that systematically assigns (and, in this case, overassigns) interest expense to nontaxable income – is constitutionally acceptable. Yet that, in substance, is the position that respondent has taken before this Court.

Rather than providing any justification for an interest allocation methodology that, in this case, assigns eight times as much interest expense to nontaxable as to taxable income (and thereby sweeps nontaxable income into the tax base),

dividends, but only \$0.13 of interest expense to each \$1.00 of taxable business income.

respondent says that "Hunt-Wesson fails to provide any explanation as to how or why any of the alternative methods which it has embraced more 'fairly' or 'rationally' allocate interest costs to classes of income." *Id.* at 33. But the explanation is self-evident. *Virtually all of the methods adopted by other States and the Federal Government for allocating interest when it cannot be directly traced to particular items of income do so in a manner that does not disproportionately assign interest to nontaxable income.* Indeed, the common theme of these methods is that they spread interest expense evenly over all of the income to which it is indirectly related. Moreover, California itself has embraced such an evenhanded methodology in other contexts, Pet. Br. 26-28, and, in fact, stands ready to apply such a methodology to other taxpayers that have challenged the interest-offset provision. Brief *Amicus Curiae* of General Electric Co. App. 1a-4a.⁵

As for respondent's contention that petitioner has not "offered any proof to this Court that it would have been entitled to deduct more interest expense from its business income under any of these alternative formulas," Resp. Br. 34, the reason for that failure is obvious. No amount of proof was relevant under the interest-offset provision. Even if petitioner had proved that all of its disallowed interest expense was directly traceable to financing its unitary operations, such interest expense still would have been denied under the interest-offset provision.

In point of fact, however, it is indisputable that petitioner would have been entitled to deduct more interest expense

⁵ In this regard, the claim of respondent and its amici that petitioner is attempting to "'constitutionalize' the manner by which states are permitted to allocate interest expense deductions between taxable and nontaxable income" (Resp. Br. 33) is nonsense. Petitioner has identified a variety of reasonable methods widely adopted by other States that do not arbitrarily and disproportionately assign interest expense to nontaxable income. Petitioner seeks only to eliminate from the broad array of constitutionally acceptable mechanisms California's unique and arbitrary method for allocating interest expense.

from its business income under any of the alternative formulas. For example, if petitioner's interest expense were allocated between its nonunitary dividends and its apportionable business income by the ratio of the nonunitary dividends to its total net income (before deducting interest expense), it would have allocated an average of fifteen cents of interest expense to each dollar of taxable and nontaxable income during the years at issue, an increase of \$64 million of deductible interest expense.⁶ The results of such an alternative method, which is derived from the undisputed facts of this case, put to rest any suggestion that California's interest-offset provision does not deprive petitioner of a substantial interest deduction.⁷

⁶ Appendix C (App. 3a) sets forth an allocation of petitioner's interest expense based on a ratio of nonbusiness dividends to total net income. As with other similar methods of allocating interest expense (e.g., a net assets method or gross income method), which have been adopted by almost every other State (Pet. Br. App. 1a-22a), this allocation method results in an evenhanded allocation of interest expense to both taxable and nontaxable income.

⁷ Respondent's contention that "Hunt-Wesson's endorsement of these alternative formulas is less than candid" because "[i]t does not ask this Court to permit it to recalculate its interest expense deduction by any one of the alternative 'fair' allocation methods," Resp. Br. 35, is untrue and, as respondent itself well knows, "less than candid." Petitioner never would have challenged California's interest allocation methodology, if it had been permitted to allocate its interest expense in the same manner that is permitted in other States. See Pet. Br. App. 1a-22a. Moreover, respondent's suggestion that petitioner should ask this Court to recalculate its interest expense in accordance with a reasonable allocation methodology is disingenuous, to say the least. Respondent has stipulated to the refund to which petitioner is entitled should it prevail in this litigation. Second Supplement to Joint Stipulation of Facts (J.A. 31). Finally, respondent's assertion that petitioner "continues to maintain, without hint of compromise, that none of the more than \$273 million in interest expense incurred during the years in issue was in any way related to the approximately \$75 million of nonbusiness dividends which its investments generated" (Resp. Br. 35) is misleading. Petitioner has maintained, consistent with the stipulated facts, that there was no evidence of any

Furthermore, when this Court has considered analogous questions, it has likewise endorsed an interest expense methodology that assigns interest between taxable and nontaxable income on a nondiscriminatory basis. Thus the very cases that respondent cites for the settled proposition that "immunity from taxation need not be total, but may instead be limited by charging such non-taxable income with its fair share of related expenses" (Resp. Br. 16) reaffirm petitioner's essential position here: that expenses must be assigned evenhandedly between taxable and nontaxable values. For example, in *United States v. Atlas Life Ins. Co.*, 381 U.S. 233 (1965), this Court sustained a pro-rata methodology for determining the extent to which an insurance company could reduce its taxable investment income by its tax-exempt interest. In so holding, the Court articulated the rule that lies at the heart of petitioner's case: "We see no sound reason, legal or economic, for distinguishing between the taxable and nontaxable dollar. . . ." *Id.* at 249. The same principle applies here: There is no sound legal or economic reason for the interest-offset provision's differential treatment of the taxable and nontaxable dollar, assigning a disproportionate amount of interest expense to the latter. See also *First Nat'l Bank v. Bartow County Bd. of Tax Assessors*, 470 U.S. 583 (1985) (sustaining pro rata deduction of tax-exempt federal obligations from taxable and nontaxable assets).⁸

relationship between the disallowed interest expense and the nontaxable income, but it has never suggested that *none* of such interest expense could not fairly be attributed to its nontaxable income under a reasonable allocation methodology. It was respondent's application of the draconian interest-offset provision "without the hint of compromise" that sparked this controversy, not petitioner's alleged intransigence.

⁸ For this reason, respondent's attempt to minimize the force of *National Life Ins. Co. v. United States*, 277 U.S. 508 (1928) (Pet. Br. 21-22), is misguided. *National Life* (and its progeny) squarely stand for the proposition, on which petitioner's case rests, that one may not be denied a deduction merely because one receives income that is tax free. That, of course, is exactly what the interest-offset provision does. Moreover, even if some portion of petitioner's interest expense could reasonably be attributed

Respondent's claim that the interest-offset provision is attempting "to plug a destructive tax loophole" (Resp. Br. 12) that allows corporations to invest equity capital to generate nontaxable income while investing borrowed funds to generate taxable income does not justify the adoption of a mechanism that arbitrarily attributes interest expense to nontaxable income.⁹ Indeed, the "loophole" is easily plugged, as virtually every other State faced with the problem has plugged it, by assigning "fungible" interest expense to taxable and nontaxable income on an evenhanded basis. Furthermore, respondent's claim that the interest-offset provision is designed merely to "level[] the playing field" (*id.* at 28) between debt and equity investments is belied by the statute's operation. Far from "leveling the playing field," by assigning an arbitrary and, here, disproportionate amount of interest expense to nontaxable income, California has tilted the playing field against those who earn nontaxable income.

In the end, California's fungibility argument stumbles on its own premise. If money is indeed fungible, and interest expense cannot reliably be traced to its ultimate use, then it follows that interest expense should be assigned on an evenhanded basis to all of the income to which it is fungibly related. That is precisely what is accomplished by almost all of the generally accepted methods for assigning "fungible" interest expense to income. That is also the approach that this Court has sanctioned when confronted with the question of how interest expense should be allocated between taxable and nontaxable income. By contrast, the interest-offset provision

to its tax-exempt income under a rational allocation formula, *National Life* would continue to bar a State's denial of the balance of the expense.

⁹ It is questionable whether the problem California has identified is properly characterized as a "loophole," since the income that California cannot tax is taxable by the State of the taxpayer's domicile. The stipulated facts provide that petitioner's nonunitary dividends, which were not subject to tax in California, "were taxable by the State of Illinois, Beatrice's state of domicile, during the fiscal years at issue." Stip. ¶ 8 (J.A. 19).

is at war with the concept of fungibility by assigning (and, in this case, overassigning) interest expense to nontaxable income on an arbitrary basis.

D. The Court's "Fair Apportionment" Decisions Have No Bearing on the Issues Raised Here

The indefensibility of the interest-offset provision as a fair method of allocating interest expense to income (even under respondent's "fungibility of money" theory) has understandably induced respondent to shift the focus of its argument from the questions petitioner has raised – whether the interest-offset provision effectively taxes extraterritorial income and discriminates against interstate commerce – to a question petitioner has not raised – whether California's tax is fairly apportioned. Resp. Br. 23-26. Respondent's goal in redirecting the inquiry is transparent: It seeks to place itself under the umbrella of the Court's decisions that have recognized the difficulty of ascertaining precisely what share of a taxpayer's apportionable tax base should be assigned to a State. Because of that difficulty, these decisions have declined to overturn the application of reasonable apportionment formulas to a taxpayer's apportionable tax base so long as the formulas achieve "rough approximation" and do not lead to a "grossly distorted result." *Id.* at 25. The Court's "fair apportionment" decisions, and their forgiving constitutional standards, have no application here for several reasons.

First, there is no support for the proposition that, regardless of the nature of a constitutional challenge to an apportioned tax, the validity of the challenge will be determined by asking simply whether the tax is fairly apportioned. In *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388 (1984), for example, this Court considered a Commerce Clause challenge to New York's fairly apportioned corporate income tax, which contained an export credit for Domestic International Sales Corporations (DISCs) that favored in-state over out-of-state activity. The New York State Tax Commission, like respondent here, sought to deflect the attack on the ground that the tax was fairly apportioned. This Court responded:

The fact that New York is attempting to tax only a fairly apportioned percentage of a DISC's accumulated income does not insulate from constitutional challenge the State's method of allowing the DISC export credit. New York's apportionment procedure determines what portion of a business' income is within the jurisdiction of New York. Nothing about the apportionment process releases the State from the constitutional restraints that limit the way in which it exercises its taxing power over the income within its jurisdiction.

Id. at 398-99.

Here, too, any suggestion that California's tax may be fairly apportioned is beside the point. Petitioner is challenging the interest offset not because it leads to malapportionment, but because, under the guise of denying a deduction, it assigns to California income that California has no power to tax and discriminates against interstate commerce. If California arbitrarily added ten percent to the income of any taxpayer who earned nontaxable income, it could not seriously defend the tax on the ground that the resulting tax did not create a "grossly distorted result." Nor may respondent defend a mechanism that systematically sweeps nontaxable income into the tax base through an arbitrary assignment of interest expense on the ground that it does not create a "grossly distorted result."¹⁰

¹⁰ *Amerada Hess Corp. v. Director, Div. of Taxation*, 490 U.S. 66 (1989), is of no assistance to respondent. In *Amerada Hess*, the taxpayer challenged New Jersey's denial of a deduction for windfall profit taxes on the theory that the State was unconstitutionally denying a deduction for an out-of-state expense. But the Court pointed out that "it is inappropriate to consider the windfall profit tax as an out-of-state expense," *id.* at 74, because it was incurred in the course of the taxpayer's unitary business. Here, by contrast, the out-of-state income that is effectively added to the taxpayer's apportionable tax base concededly does not derive from the taxpayer's unitary business. Hence, any analogy between the unitary out-of-state expense in *Amerada Hess* and the petitioner's nonunitary out-of-state dividends rests on a false comparison.

Second, these relaxed standards of constitutional adjudication apply only to apportionment formulas that are not "inherently" (*Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 121 (1920)) or "intrinsically" (*Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123, 133 (1931)) arbitrary. The interest-offset provision does not meet this standard. Unlike income apportionment formulas, which spread income evenhandedly among the States in which a taxpayer does business on the basis of one or more apportionment factors reflecting in-state activity, the interest-offset provision arbitrarily assigns income to a State based merely on the taxpayer's receipt of nonunitary dividends and without regard to any factor or factors reflecting in-state activity. Hence the presumption of correctness that applies to the application of reasonable apportionment formulas has no application here.

In short, this case does not involve a challenge to the application of a theoretically defensible formula to a taxpayer's unitary tax base to determine whether the State is taxing a fairly apportioned "slice" of a concededly apportionable "pie." Rather, it involves a challenge to a theoretically flawed mechanism that looks to admittedly nonapportionable income in determining the amount of a deduction (and, hence, the amount of income) that the State may tax.

E. It Is No Defense That California's Interest-Offset Provision Is "Internally Consistent"

Respondent also seeks to defend the constitutionality of the interest offset on the ground that it satisfies this Court's "internal consistency" test for evaluating the validity of state taxes under the Commerce Clause. It is true, of course, that if a tax is *not* internally consistent – i.e., if its hypothetical replication by every State would burden interstate commerce – the statute is *not* constitutional. See, e.g., *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984). But it does not follow that if a tax *is* internally consistent, the tax *is* constitutional. Indeed, such reasoning is fallacious both as a matter of logic and as a matter of law.

As a matter of logic, the argument founders on the elementary proposition that the inverse of a statement is not necessarily true. For example, it is true that if an animal does *not* have four legs, it is *not* a dog. But it does not follow that if an animal *does* have four legs, it *is* a dog. Yet that is the underlying "logic" of respondent's analysis.

What is true as a matter of logic is also true as a matter of law. Statutes that are "internally consistent" are not necessarily constitutional. For example, reciprocity statutes, such as those at issue in *New Energy Co. v. Limbach*, 486 U.S. 269 (1988), are "internally consistent." In that case, Ohio offered a tax credit for fuel containing ethanol produced in Ohio or in any State that granted a similar credit for Ohio-produced fuel. If every State had adopted Ohio's scheme, there would be no discrimination against interstate commerce, because the credit would be available in every State. Yet this Court had no hesitation in unanimously condemning the tax as unconstitutionally discriminatory. Quoting its earlier decision in *Great Atl. & Pac. Tea Co. v. Cottrell*, 424 U.S. 366 (1976), in which it had likewise invalidated an "internally consistent" reciprocity scheme, the Court declared that " 'Mississippi may not use the threat of economic isolation as a weapon to force sister States to enter into even a desirable reciprocity agreement.' " *New Energy*, 486 U.S. at 274 (quoting *Great Atlantic*, 424 U.S. at 378). Nor may California.

Indeed, the pernicious consequences of respondent's argument are self-evident. Today California stands alone among the States in arbitrarily assigning interest expense to business and nonbusiness income by an interest-offset mechanism. See Pet. Br. 26-28; *Id.* at App. 1a-22a. Virtually every other State assigns interest to business and nonbusiness income by a mechanism that seeks to attribute interest to *related* business and nonbusiness income. *Id.* As a consequence, when California arbitrarily assigns interest expense to unrelated nonbusiness dividends, it is simply not true that "the offset interest expense would be recognized and have the effect of reducing its tax liability in . . . its State of domicile." Resp. Br. 27. To the contrary, other States will allow only the portion of the expense that is *related* to the nonbusiness

dividend, which, as in this case, will ordinarily be considerably less than the dollar-for-dollar offset that California assumes. And this is so whether the interest expense is allocated on a direct tracing basis or by some rational allocation according to the ratio of business to nonbusiness income or the assets producing such income.

II. THE INTEREST-OFFSET PROVISION PLAINLY FAVORS DOMICILIARY OVER NONDOMICILIARY CORPORATIONS IN VIOLATION OF THE COMMERCE CLAUSE

The interest-offset provision discriminates against nondomiciliary corporations for the simple reason that it denies a nondomiciliary corporation, but not a domiciliary corporation, a deduction for interest expense equal to the corporation's nonunitary dividends. The discrimination cannot be justified as a method for matching a corporation's interest expense to its taxable income because, as we have already explained at length, the interest deduction is denied to the nondomiciliary and granted to the domiciliary regardless of any relationship between the interest expense and the nonunitary dividends. Consequently, the denial or grant of the deduction depends entirely on the corporation's domicile in violation of settled Commerce Clause principles.

Respondent does not – and could not – deny our description of the practical effect of the statute. Instead, it seeks to defend the statute by suggesting that the appropriate comparison for Commerce Clause purposes is not between domiciliary and nondomiciliary corporations but "between corporations that operate on borrowed money while simultaneously holding investments which generate income exempt from California tax and corporations that do not hold such investments and devote their entire capital to their business operations. . . ." Resp. Br. 40. The contention has no support in this Court's Commerce Clause jurisprudence.

It is true, of course, that "any notion of discrimination assumes a comparison of substantially similar entities." *General Motors Corp. v. Tracy*, 519 U.S. 278, 298 (1997). In this

case, two corporations identical in every respect except for their State of domicile clearly are "substantially similar entities" for purposes of a discrimination analysis under the Commerce Clause. *See, e.g., South Cent. Bell Tel. Co. v. Alabama*, 526 U.S. 160 (1999). Indeed, if respondent's gerrymandered definition of "substantially similar entities" could inform Commerce Clause analysis, it would invite the very type of "economic Balkanization" that the Commerce Clause was designed to prevent, *Hughes v. Oklahoma*, 441 U.S. 322, 325 (1979), by permitting States to favor in-state over out-of-state corporations under the guise of a constricted classification of "substantially similar entities."¹¹

¹¹ For reasons set forth above (*see supra* pp. 13-15), respondent's defense to the claim that the interest-offset provision is discriminatory on the theory that it is "internally consistent" (Resp. Br. 42-43) has no support in logic or law. Moreover, respondent's Pollyannaish assumption that the discriminatory effects of the interest-offset rule would be offset by similarly discriminatory regimes in other States (*id.* at 43) simply ignores the fact that no other State has an interest-offset regime like California's. *See* Pet. Br. App. 1a-22a. Furthermore, respondent's claim that the "anti-discrimination principle of the Commerce Clause 'has not in practice required much in addition to the requirement of fair apportionment,'" Resp. Br. 42 (quoting *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 171 (1983)), ignores the context in which the Court made that statement. In *Container*, the Court's remarks were directed to the requirement that "[b]esides being fair, an apportionment formula must, under the Commerce Clause, also not result in discrimination against interstate or foreign commerce." *Container*, 463 U.S. at 170 (emphasis supplied). These remarks have no bearing on a claim of discrimination, such as petitioner's claim here, that is independent of (and takes no issue with) the constitutionality of the state's apportionment formula. *See Amerada Hess*, 490 U.S. at 75 ("Even if a tax is fairly apportioned, it may discriminate against interstate commerce."); *Westinghouse*, 466 U.S. at 399 (" 'fairly apportioned' and 'nondiscriminatory' are not synonymous terms").

III. RESPONDENT HAS OFFERED NO SERIOUS DEFENSE OF ITS TAX PREFERENCE FOR NON-DOMICILIARY CORPORATIONS RECEIVING NONUNITARY DIVIDENDS FROM SUBSIDIARIES THAT DO BUSINESS IN CALIFORNIA

Even if California were constitutionally free to deny petitioner an interest deduction equal to its nonunitary dividends, petitioner would be entitled nevertheless to an interest deduction because of the second constitutional defect in Cal. Rev. & Tax. Code § 24344 – the selective allowance of an interest deduction corresponding to the extent of the petitioner's dividend-paying subsidiaries' in-state activities. There can be little question that California's taxing scheme is unconstitutional in light of the Court's recent decision in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), striking down a similar scheme. Nothing in respondent's brief casts any doubt on that conclusion.

First, respondent's suggestion that this issue is not properly before this Court is preposterous. It was squarely raised in the Questions Presented (Pet. i (Question 2)), and, indeed, has been in controversy throughout this litigation. *See, e.g., J.A.* 64. Nor is petitioner's challenge "little more than a disguised attack on section 24402," not that this would matter. Petitioner's challenge is directed to the simple and indisputable fact that, under section 24344, it is entitled to an interest expense deduction equal to the amount of its nonunitary dividends *only* to the extent those dividends reflect the subsidiaries' in-state business activity. Whether this limitation reflects other discriminatory features of California's tax code is of no concern to petitioner. Petitioner's challenge is unequivocally focused solely on the discriminatory denial of an interest deduction under Cal. Rev. & Tax. Code § 24344.¹²

¹² As respondent notes, other taxpayers *are* challenging the constitutionality of section 24402, which limits a corporation's dividends received deduction to dividends reflecting income previously taxed by California. *See First Credit Bank & Subsidiary v. Franchise Tax Bd.*, Los Angeles Cty. Sup. Ct., No. BC 205481. The only relevance of section

Second, respondent's contention that the statute is applied in a nondiscriminatory manner because "all dividends declared from income already subjected to California tax are excluded from the interest offset computation" (Resp. Br. 45) is downright silly. That is exactly the point – any foreign corporation that invests in a nonunitary subsidiary doing business in California is entitled to the interest expense deduction and any foreign corporation that invests in a nonunitary subsidiary doing business elsewhere is not.

Third, respondent's effort to distinguish *Fulton* is futile. Initially, respondent seeks to rescue California's statute by reference to its purpose. It contends that the statute survives Commerce Clause scrutiny because it was "intended 'to avoid double taxation at the corporate level of income which has already been subjected to California taxation in the hands of the dividend-declaring corporation.'" Resp. Br. 46 (quoting *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 7 Cal. 3d 544, 548 n.4 (1972)).¹³ This allegedly benign intent might protect the statute's disparate treatment of corporations with in-state subsidiaries and corporations with out-of-state subsidiaries from attack under the Equal Protection Clause. For Commerce Clause purposes, however, it is insufficient. It is well established that a determination that a state tax violates the Commerce Clause "may be made on the basis of either discriminatory purpose . . . or discriminatory effect." *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 270 (1984) (citations omitted). The discriminatory effect of favoring investments in in-state over out-of-state corporations is incontrovertible, and this Court in *Fulton* rejected a virtually identical avoidance-

24402 to this case is *descriptive*: it describes those dividends the receipt of which entitles a taxpayer to an interest deduction.

¹³ In advancing this argument, respondent implicitly acknowledges that the interest-offset provision, in fact, operates to impose a second tax upon the nonbusiness dividends not taxable by California, thereby creating the need for the exemption. This is in clear contradiction of its earlier statement that the interest-offset provision does not result in the taxation of such dividends. Resp. Br. 36.

of-double-taxation defense pressed by North Carolina. See *Fulton Corp.*, 516 U.S. at 344-46.

Nor does respondent advance the analysis by suggesting that, inasmuch as the dividend-producing income has already been taxed in California, "no advantage is afforded to California subsidiaries over foreign subsidiaries" because "[t]he exemption does nothing more than compensate for the earlier taxation of the dividend-producing income by California. . . ." Resp. Br. 47. The observation is irrelevant to the question before the Court. The question is not whether the interest-offset provision favors the dividend-paying corporation; the question is whether it favors the dividend-receiving corporation. Plainly it does, because only dividend-receiving corporations with in-state subsidiaries are entitled to the benefit of the interest expense deduction.

Respondent's contention that California's goal of avoiding double taxation "cannot be adequately served by reasonable nondiscriminatory alternatives," *id.* at 48 n.29 – which concedes the essential point that the statute *is* discriminatory – is groundless. If California wants to avoid double taxation of corporations and their subsidiaries, it need only allow a dividends received deduction for dividends received from all subsidiaries, whether or not they do business in California. Only in respondent's California-centric view of the federal system can such a nondiscriminatory deduction be considered as a "loophole," *id.*, since any subsidiary that had not already been taxed in California would likely have been taxed in one or more of the other 45 States and the District of Columbia that impose corporate income taxes. 1 All States Tax Guide (CCH) ¶ 10-050 (1999). Equal treatment of in-state and out-of-state taxpayers, which takes account of burdens imposed by other States, is the hallmark of this Court's Commerce Clause jurisprudence. See, e.g., *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 192-93 n.6 (1995).

Finally, respondent's attempt to distinguish *Fulton* and to justify California's discriminatory denial of an interest expense deduction to taxpayers investing in out-of-state subsidiaries on the ground that it is "internally consistent" (Resp. Br. 49) fails for the same reason that its "internal consistency"

defense failed with respect to the general denial of an interest deduction for taxpayers receiving nonunitary dividends: merely because a tax is internally consistent does not mean that it is constitutional. *See supra* pp. 13-15 & p. 16 n.11. In this context too, the reason why "internal consistency" is not a *defense* to the constitutionality of a discriminatory statute is apparent. Because no other State has adopted an interest-offset provision like California's, Pet. Br. 28-32; *id.* at App. 1a-22a, respondent's claim that "the level of in-state activity does not affect a corporation's overall tax liability, but affects merely the extent to which interest expense is allocated between sources in and out of California" (Resp. Br. 49) is pure fantasy. In fact, when a nondomiciliary corporation invests in an out-of-state, nonunitary subsidiary, it stands to lose its California interest deduction, on a dollar-for-dollar basis, to the full extent of any dividends paid by that subsidiary, and it will never be able to deduct the amount of interest expense that other States will attribute to California under the non-discriminatory interest expense allocation regimes in force in those States.

CONCLUSION

For the foregoing reasons, the judgment of the California Court of Appeal should be reversed.

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APPENDIX A

MTC SCHEDULE 1205

INTEREST OFFSET - CALIFORNIA

Total Interest Expense ¹	_____	_____	_____
Non-Business Portion	_____	_____	_____
A. NET INTEREST EXPENSE	(_____)	(_____)	(_____)
	=====	=====	=====
Total Interest Income	_____	_____	_____
Non-Business Portion	(_____)	(_____)	(_____)
B. BUSINESS INTEREST INCOME	=====	=====	=====
C. EXCESS A. OVER B.	=====	=====	=====
Total Non-Business Dividend Income	_____	_____	_____
Non-Business Interest Income	_____	_____	_____
Total Deductible Dividends	(_____)	(_____)	(_____)
D. BALANCE	=====	=====	=====
INTEREST OFFSET (lesser of C or D)	=====	=====	=====

TO SCHEDULE 1105

¹ Water's Edge filers who are subject to the foreign dividend interest offset are required to reduce total interest expense by foreign interest expense to offset the foreign dividend deduction.

APPENDIX B

Application of California's Interest Offset Formula To Hunt-Wesson*

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>Total</u>
1. Total Interest Expense	\$ 80,490,469	\$ 55,101,503	\$ 137,413,162	\$ 273,005,134
2. Less: Unitary Business Interest Income (A)	\$ 10,217,578	\$ 21,389,332	\$ 83,920,105	\$ 115,527,015
3. Balance (B)	\$ 70,272,891	\$ 33,712,171	\$ 53,493,057	\$ 157,478,119
4. Less: Nonbusiness Dividend Income (C)	\$ 26,718,620	\$ 29,482,367	\$ 19,022,617	\$ 75,223,604
5. Balance (B minus C)=(D)	\$ 43,554,271	\$ 4,229,804	\$ 34,470,440	\$ 82,254,515
6. Total Interest Expense Subject to apportionment in California (A plus D)=(E)	\$ 53,771,849	\$ 25,619,136	\$ 118,390,545	\$ 197,781,530
7. Interest Offset (Lesser of B or C)=(F)	\$ 26,718,620	\$ 29,482,367	\$ 19,022,617	\$ 75,223,604
8. Business Income (G)	\$ 500,434,037	\$ 487,922,753	\$ 575,711,747	\$ 1,564,068,537
9. Amount of Interest Expense Allocated To Each Dollar of Nonbusiness Dividend Income (F/C)	\$ 1.00	\$ 1.00	\$ 1.00	\$ 1.00
10. Amount of interest Expense Allocated to Each Dollar of Business Income (E/G)	\$ 0.1075	\$ 0.0525	\$ 0.2056	\$ 0.1265
11. Percentage Increase in Interest Expense Allocated to Nonbusiness Income Under Interest Offset	830%	1805%	386%	691%

* This table is identical to the table set forth in the appendix to Brief for Respondent, Resp. Br. at 1a, except lines 8-11 have been added. Line 8 sets forth petitioner's total business income; the source for this information is at Clerk's Transcript ("CT") p. 83. Lines 9, 10, and 11 are merely computational and do not reference the record.

APPENDIX C

Use of Net Income Method to Allocate Interest Expense To Business and Nonbusiness Income

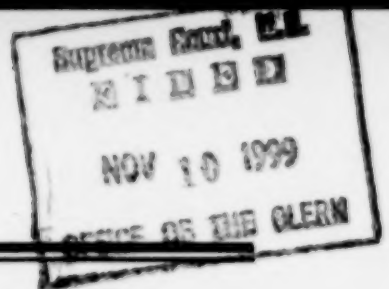
	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>Total</u>
1. Total Interest Expense (A)	\$ 80,490,469	\$ 55,101,503	\$ 137,413,162	\$ 273,005,134
2. Nonbusiness Dividends (B)	\$ 26,718,620	\$ 29,482,367	\$ 19,022,617	\$ 75,223,604
3. Unitary Domestic Net Income (C) ¹	\$ 458,872,375	\$ 436,934,025	\$ 521,709,407	\$ 1,417,515,807
4. Unitary Foreign Net Income (D) ²	\$ 37,425,467	\$ 43,625,313	\$ 50,348,114	\$ 131,398,894
5. Total Unitary Net Income Before Deducting Interest Expense (A+C+D)=(E) ³	\$ 576,788,311	\$ 535,660,841	\$ 709,470,683	\$ 1,821,919,835
6. Ratio of Nonbusiness Dividends (B) To Total Unitary Net Income (B/E)=(F)	4.632310%	5.503924%	2.681241%	4.128810%
7. Interest Expense Allocable To Nonbusiness Income (A x F)=(G)	\$ 3,728,568	\$ 3,032,745	\$ 3,684,378	\$ 11,271,863
8. Interest Expense Allocable To Business Income (A-G)=(H)	\$ 76,761,901	\$ 52,068,758	\$ 133,728,784	\$ 261,733,271
9. Amount Of Interest Expense Allocable to Each Dollar of Business Income Under Income allocation (H/(E-B))	\$ 0.1395	\$ 0.1029	\$ 0.1937	\$ 0.1498
10. Amount Of Interest Expense Allocable To Each Dollar of Nonbusiness Dividends Under Income Allocation (G/B)	\$ 0.1395	\$ 0.1029	\$ 0.1937	\$ 0.1498
11. Amount of Interest Expense Allocated To Each Dollar of Nonbusiness Dividends Under Interest Offset	\$ 1.00	\$ 1.00	\$ 1.00	\$ 1.00
12. Interest Expense Allocable to Nonbusiness Income Under Interest Offset	\$ 26,718,620	\$ 29,482,367	\$ 19,022,617	\$ 75,223,604
13. Percentage Increase in Interest Expense Allocated to Nonbusiness Income Under Interest Offset	617%	872%	416%	568%

¹ Clerk's Transcript ("CT") at p. 85. (Includes DISC Income and Nonbusiness Dividends).

² CT at p. 85. (Includes Nonbusiness Dividends).

³ Interest expense (A) is added back to Total Unitary Net Income to arrive at Net Income before deducting interest expense.

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No. 98-2043



IN THE
Supreme Court of the United States

HUNT-WESSON, INC.,
Petitioner,
v.

FRANCHISE TAX BOARD,
Respondent.

On Writ of Certiorari to the
Court of Appeal of California
for the First Appellate District

BRIEF OF
TAX EXECUTIVES INSTITUTE, INC.
AS AMICUS CURIAE
IN SUPPORT OF PETITIONER

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BRIEF OF
TAX EXECUTIVES INSTITUTE, INC.
AS *AMICUS CURIAE*
IN SUPPORT OF PETITIONER

INTEREST OF *AMICUS CURIAE*

Pursuant to Rule 37 of the Rules of the Supreme Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae* in support of Petitioner.¹ Tax

¹ Pursuant to Rule 37.6, *amicus* TEI states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Tax Executives Institute has received the written consents of Petitioner and Respondent to the filing of this brief; those consents have been filed with the Clerk of the Court.

Executives Institute (hereinafter "TEI" or "the Institute") is a voluntary, nonprofit association of corporate and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. The Institute was organized in 1944 and currently has approximately 5,000 members who represent nearly 2,800 of the leading businesses in the United States and Canada, nearly all of which are engaged in interstate commerce.

The members of the Institute represent a cross-section of the business community in North America. The Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws throughout the Nation, to reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers, and to vindicating the due process and Commerce Clause rights of business taxpayers.

Tax Executives Institute's members have a vital interest in this case, which involves the unconstitutional effect of the so-called interest-offset rule in section 24344 of the California Revenue and Taxation Code. Many of the companies represented by TEI are directly and adversely affected by the interest-offset rule, which reduces a company's interest expense deduction for each dollar of dividends received from non-unitary subsidiaries. Even those TEI members whose companies are not doing business in California are, almost without exception, engaged in interstate commerce. Consequently, they benefit from, and are entitled to, the positive business environment ensured by the Commerce Clause and Due Process Clause of the United States Constitution.

Because TEI members and the businesses by which they are employed will be materially affected by the Court's decision in this case, the Institute has a special interest in the outcome of this case.

SUMMARY OF ARGUMENT

The question presented in this case is whether the State of California's system of taxation for out-of-state companies violates the Commerce Clause and Due Process Clause of the Constitution. It is well settled that a State may not tax value outside its borders. Such taxation is proscribed because the "fundamental purpose of the [Commerce] Clause is to assure that there be free trade among the several States," *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 335 (1977), and because extraterritorial taxation offends fundamental notions of due process and constitutes an "unreasonable clog on the mobility of commerce," *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 527 (1935).

Like many states, California imposes a corporate franchise tax for the privilege of doing business in the State, using an apportionment formula in respect of corporations with income from sources within and without the State. In calculating a taxpayer's net taxable income, business interest expense is generally deducted from business income. Under section 24344 of the California Revenue and Taxation Code, however, taxpayers must offset their business interest expense—on a dollar-for-dollar basis—with non-business income not allocable to the State. Thus, out-of-state corporations (such as Petitioner Hunt-Wesson) are compelled to reduce their interest deduction by the amount of their nontaxable income, *without regard to whether the interest expense is related to the nontaxable income*. It is this statute that is at issue here.

In this case, the trial court concluded that section 24344 violates the Due Process, Commerce, and Equal Protection Clauses of the Constitution. This latter decision was reversed by the Court of Appeal, First Appellate District, largely on the force of the Supreme Court of California's

1972 decision in *Pacific Tel. & Tel. Co. v. Franchise Tax Board*, 7 Cal. 3d 544 (1972). Subsequent decisions of this Court, however, unequivocally demonstrate that the State's 1972 decision cannot stand. *South Central Bell Tel. Co. v. Alabama*, 119 S. Ct. 1180 (1999); *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996); *Oregon Waste Systems, Inc. v. Department of Environmental Quality*, 511 U.S. 93 (1994).

In *Pacific Telephone*, the taxpayer challenged the California interest-offset statute as it applied to nondomiciliary corporations. In reviewing the rule, the California Supreme Court conceded that "when viewed in the light of a domiciliary corporation," the rule "does not deprive the taxpayer of any of its interest deduction, but is merely an attempt to provide how the interest expense shall be allocated as between income from operations and income from investments." 7 Cal. 3d at 551 (emphasis in original). The court also commented that the allocation of interest expense is "very favorable" to the domiciliary corporation. *Id.* As applied to out-of-state companies, however, the allocation is manifestly *not* favorable. Hence, on its face, the rule violates the overarching principle of the Commerce and Due Process Clauses that an apportionment formula must, first and foremost, be fair. *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 169 (1983).

Commerce Clause jurisprudence has evolved significantly since California's decision in *Pacific Telephone*. Nowhere has this evolution been more profound than in respect of statutory schemes that facially discriminate against out-of-state commerce. Last term, in *South Central Bell*, this Court invalidated Alabama's franchise tax as facially discriminatory because it gave "domestic corporations the ability to reduce their franchise tax liability simply by reducing the par value of their stock, while it denies

foreign corporations that same ability." 119 S. Ct. at 1185. Five years ago, in *Oregon Waste*, the Court similarly struck down a surcharge on the disposal of waste generated out of state, holding that the taxing scheme was virtually *per se* invalid. *Id. Accord Fulton Corp.*, 516 U.S. at 331.

By its very terms, the interest-offset rule at issue here violates the Commerce Clause. As the trial court found, "the offset provisions treat two corporations in an identical business transaction differently based solely on their state of domicile, which difference results in increased taxes for foreign corporations." (App. at 28a-29a.)² Under extant Commerce Clause jurisprudence, the California statute must therefore fall.

The law also offends the Due Process Clause, which requires a minimal connection between the interstate activities and the taxing State, as well as a rational relationship between the income attributed to the taxing State and the intrastate value of the corporate business. *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 772-73 (1992) (citations omitted). California does not contend that the non-business income at issue here bears any relation to Petitioner's in-state activities. Rather, the State seeks to tax Petitioner's extraterritorial activities by requiring a dollar-for-dollar offset of constitutionally protected income against interest expense.

Under *Allied-Signal*, a State may tax dividend income *only* where the payee and payer of the dividend are engaged in a unitary business or the capital transaction serves an operational—rather than an investment—func-

² "App." references are to the various appendices bound with the Petitioner's Petition for a Writ of Certiorari to the Court of Appeal of California for the First Appellate District in *Hunt-Wesson, Inc. v. Franchise Tax Board*, No. 98-2043 (filed June 21, 1999).

tion. 504 U.S. at 787. The dividend income sought to be taxed here bears no relationship to Petitioner's in-state activities and thus California's covert attempt to tax it should be rejected as violative of due process.

Moreover, the State's semantics—that the interest-offset rule is not a “tax” and therefore the precedents of this Court are not controlling—cannot change the substance of the statute. It is clear that California could not tax Petitioner's dividend income directly. It is also clear that a State may not, through constitutional alchemy, indirectly tax constitutionally protected income.

In *Allied-Signal*, the Court validated the “necessary limit on the States' authority to tax value or income that cannot in fairness be attributed to the taxpayer's activities within the State.” 504 U.S. at 780. The state court did not dispute this holding. Indeed, although rejecting the Petitioner's challenge on *stare decisis* grounds, it acknowledged that “[i]f we were writing on a clean slate, these arguments [against the interest-offset rule] might appear persuasive.” (App. at 8a.) This Court can wipe the slate clean by striking down the interest-offset rule because it violates the Due Process Clause of the Constitution.

For the foregoing reasons, the Court should reverse the decision below.

ARGUMENT

I.

The question presented here is whether the State of California's system of taxation for out-of-state companies violates the Commerce Clause and Due Process Clause of the Constitution.³ That California's taxation scheme can-

³ U.S. CONST. art. I, § 8, cl. 3 (Commerce Clause); U.S. CONST. amend. XIV, § 1 (Due Process Clause).

not pass constitutional muster was made manifest in this Court's decision in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996). In that case, the Court examined a North Carolina intangibles tax on the fair market value of stock owned by state residents. Under the state statute, residents owning stock in a corporation earning income solely within the state paid no intangibles tax, whereas residents with stock of foreign corporations having no in-state activities paid the full amount. Because the tax was computed on a different net base depending on the corporation's in-state activities, it was “virtually *per se* invalid.” 516 U.S. at 331, 333 & n.3. The same constitutional infirmity characterizes the California tax here.

It is well settled that a State may not tax value outside its borders. *E.g.*, *Connecticut General Life Ins. Co. v. Johnson*, 303 U.S. 77, 80-81 (1938). Such taxation is proscribed because the “fundamental purpose of the [Commerce] Clause is to assure that there be free trade among the several States,” *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 335 (1977), and because extraterritorial taxation offends fundamental notions of due process and constitutes an “unreasonable clog on the mobility of commerce,” *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 527 (1935).

This Court has rightly observed that dividing income among the several States resembles “slicing a shadow.” *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 192 (1983).⁴ Absolute consistency among taxing authori-

⁴ The unitary business principle calculates the local tax base by first defining the scope of the unitary business of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of the unitary business between the taxing jurisdiction and the rest of the world based on a formula “taking into account objective measures of the corporation's activi-

ties "may just be too much to ask," *id.*, but there are constitutional limits on a State's use of an apportionment formula, especially in respect of income derived from foreign commerce.⁵ In other words, a balance must be struck between the State's need for revenue and the taxpayer's legitimate right to protection from overreaching taxing authorities. It is for this Court to ensure that the balance is a reasonable one. *See Boston Stock Exchange*, 429 U.S. at 329 (the Court has a duty "to make the delicate adjustment between the national interest in free and open trade and the legitimate interest of the individual States in exercising their taxing powers"). If the State has not "given anything for which it can ask return" in respect of the person, property, or transaction it seeks to tax, *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940), the Commerce and Due Process Clauses operate as a constitutional brake upon the State's raw power to tax. The overarching principle of the Commerce and Due Process Clauses is that an apportionment formula must, first and foremost, be fair. *Container Corp.*, 463 U.S. at 169.

ties within and without the jurisdiction." *Container Corp.*, 463 U.S. at 165. Although the terms "allocation" and "apportionment" are often used interchangeably in respect of the division of income among various jurisdictions, "allocation" properly refers to the "attribution of a particular type of income to a designated state, [and] 'apportionment' refers to the division of the tax base by formula." JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *STATE TAXATION I: CORPORATE INCOME AND FRANCHISE TAXES* ¶ 9.01 (3d ed. 1998).

⁵ In evaluating challenges to state taxing schemes, the Court examines the practical effect of a challenged tax to determine whether it "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

Like many states, California imposes a corporate franchise tax for the privilege of doing business in the State, which is based on the net income derived from or attributable to sources within the State. CAL. REV. & TAX CODE §§ 23151 & 25101 (West 1992). Consistent with the constitutional requirements for corporations doing business both inside and outside the State, taxability of income turns first on the unitary business principle which allocates income to the State—*i.e.*, on whether the out-of-state item sought to be taxed is "unitary" with, or functionally related to, the taxpayer's in-state activities. The amount of operating income earned in California is then determined by calculating the net operating income of the unitary business and apportioning part of it to California by use of a formula.⁶ For the years in issue, California used the apportionment formula set forth in the Uniform Division of Income for Tax Purposes Act (UDITPA), which compares (i) the taxpayer's property, payroll, and sales (receipts) within the taxing State to (ii) the taxpayer's total property, payroll, and sales. CAL. REV. & TAX CODE § 25128 (West 1992) (App. at 37a); UDITPA §§ 9-17. "Non-business income"—such as dividends derived from an unrelated business activity—is neither allocated nor apportioned to the State unless the corporation is domiciled there. CAL. REV. & TAX CODE § 25126 (West 1992) (App. at 37a).

In calculating a taxpayer's net taxable income, business interest expense is generally deducted from business in-

⁶ The formulary apportionment of income by a State has been recognized by this Court as a valid means of taxation. *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 460 (1959) ("the entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs").

come. CAL. REV. & TAX CODE § 24344(a) (West 1992) (App. at 35a). Under California law, however, taxpayers must offset their business interest expense—on a dollar-for-dollar basis—with non-business income not allocable to the State. CAL. REV. & TAX CODE § 24344(b) (West 1992) (App. at 35a). Thus, out-of-state corporations (such as Petitioner Hunt-Wesson) are compelled to reduce their interest deduction by the amount of their nontaxable income, *without regard to whether the interest expense is related to the nontaxable income*. It is this statute—which increases Petitioner's California tax liability—that is at issue here.

In this case, the trial court concluded on the merits that section 24344 violates the Due Process, Commerce, and Equal Protection Clauses of the Constitution. This latter decision was reversed by the Court of Appeal, First Appellate District, largely on the force of the Supreme Court of California's decision in *Pacific Tel. & Tel. Co. v. Franchise Tax Board*, 7 Cal. 3d 544 (1972). As explained by the Court of Appeal:

Hunt-Wesson contends that the interest offset provision of section 24344 impermissibly taxes dividends which are constitutionally immune from taxation by California, and therefore violates the federal Due Process Clause. The Due Process Clause limits a state's power to impose a tax on an activity which is not connected with the taxing state. Thus, a state may not constitutionally tax income [from] dividends which a nondomiciliary corporation receives from subsidiary corporations having no other connection with the state.

Hunt-Wesson argues that the interest offset provision of section 24344 constitutes an indirect tax on immune income, increasing a nondomiciliary corpora-

tion's tax liability solely because it receives nontaxable dividends. Hunt-Wesson also argues that the interest offset [rule] is overbroad, because it fails to apportion interest expense, but creates a dollar-for-dollar offset. If we were writing on a clean slate, these arguments might appear persuasive. In *Pacific Telephone*, however, the California Supreme Court explicitly held that inclusion of nontaxable dividends in the statutory offset computation under section 24344 does not constitute taxation of the dividends themselves.

(App. at 7a-8a (citations omitted).) The Court of Appeal reached a similar conclusion in respect of Petitioner's argument that the interest-offset rule violates the Commerce Clause, but essentially held that the *Pacific Telephone* decision compelled it to sustain the statute. (App. at 9a-10a.) The California Supreme Court subsequently refused to review the case. (App. at 43a.)

The Court of Appeal's decision flows from the principle of *stare decisis*—unquestioned reliance on the *Pacific Telephone* decision. Subsequent decisions of this Court, however, unequivocally demonstrate that the 1972 decision of the California Supreme Court cannot stand. *South Central Bell Tel. Co. v. Alabama*, 119 S. Ct. 1180, 1185 (1999); *Fulton Corp.*, 516 U.S. at 327; *Oregon Waste Systems, Inc. v. Department of Environmental Quality*, 511 U.S. 93, 99 (1994). See *United States v. Gaudin*, 515 U.S. 506, 521 (1995) ("*stare decisis* cannot possibly be controlling when . . . the decision has been proved manifestly erroneous, and its underpinnings eroded, by subsequent decisions of this Court.").

II.

The Commerce Clause of the Constitution provides that "Congress shall have Power . . . [t]o regulate Commerce

. . . among the several States. . . ." U.S. CONST. art. I, § 8, cl. 3 The clause not only provides Congress with broad regulatory powers, but also embodies a negative command forbidding States from discriminating against interstate commerce. *Oregon Waste*, 511 U.S. at 98. Its fundamental purpose "is to assure that there be free trade among the several States." *Boston Stock Exchange*, 429 U.S. at 335. To effectuate this purpose, a state taxing scheme will be invalidated if it imposes a higher tax burden on foreign corporations than on domestic corporations engaged in comparable activity. *Id.* at 329 ("[p]ermitting the individual States to enact laws that favor local enterprises at the expense of out-of-state businesses 'would invite a multiplication of preferential trade areas destructive' of the free trade which the Clause protects" [citations omitted]); see *Maryland v. Louisiana*, 451 U.S. 725, 754 (1981); *Halliburton Oil Well Cementing Co. v. Reily*, 373 U.S. 64, 72-74 (1963). Justifications for discriminatory restrictions on commerce must pass the strictest scrutiny. *Oregon Waste*, 511 U.S. at 101.

In this case, the Court of Appeal felt bound by a 1972 decision of the California Supreme Court upholding the interest-offset provision. (App. at 1a.) In *Pacific Telephone*, the taxpayer challenged the California interest-offset statute as it applied to nondomiciliary corporations. In reviewing the rule, the California Supreme Court acknowledged its discriminatory effect on non-residents. Specifically, the State court conceded that "when viewed in the light of a *domiciliary* corporation," the rule "does not deprive the taxpayer of any of its interest deduction but is merely an attempt to provide how the interest expense shall be allocated as between income from operations and income from investments." 7 Cal. 3d at 551 (emphasis in original). The court also commented that

the allocation of interest expense is "very favorable" to the domiciliary corporation. *Id.* As applied to out-of-state companies, however, the allocation is manifestly *not* favorable—a fact known to the State when the interest-offset rule was enacted. *Id.* at 554 (citing a letter by the Franchise Tax Board to the Governor that the rule will "increase taxes on foreign corporations while reducing those of domestic corporations").⁷

Commerce Clause jurisprudence has evolved significantly since California's decision in *Pacific Telephone*. Nowhere has this evolution been more profound than in respect of statutory schemes that facially discriminate against out-of-state commerce. Last term, in *South Central Bell*, this Court invalidated Alabama's franchise tax as facially discriminatory because it gave "domestic corporations the ability to reduce their franchise tax liability simply by reducing the par value of their stock, while it denies foreign corporations that same ability." 119 S. Ct. at 1185. Five years ago, in *Oregon Waste*, the Court similarly struck down a surcharge on the disposal of waste generated out of state, holding that it impermissibly discriminated against interstate commerce because it provided "differential treatment of in-state and out-of-state economic interests that benefits the former and burdens the latter." 511 U.S. at 99. Indeed, the Court held that such a scheme was virtually *per se* invalid. *Id.* *Accord* *Fulton Corp.*, 516 U.S. at 331 (quoting the "virtually *per se* invalid" language of *Oregon Waste* in striking down an intangibles tax that was discriminatory on its face).⁸

⁷ The constitutional aspects of the statute were apparently not challenged in *Pacific Telephone*.

⁸ Several other decisions of this Court since *Pacific Telephone* also undermine that decision's continuing vitality. See *Campa*

By its very terms, therefore, the California rule violates the Commerce Clause. The trial court here acknowledged the discrimination Petitioner was subjected to: "[T]he offset provisions treat two corporations in an identical business transaction differently based solely on their states of domicile, which difference results in increased taxes for foreign corporations." (App. at 28a-29a.) Hence, if Petitioner's subsidiaries were domiciled in California, they would not face the double taxation effected by the interest-offset rule. Clearly, for some companies enduring the rigamarole of relocating their domicile within the State may be economically worthwhile (compared with the level of double taxation they could avoid), but other taxpayers may not have that flexibility owing to the nature of their businesses or the regulatory regimes in other States.⁹ This option, moreover, would not be effective should other States choose to enact similar schemes.¹⁰ More fundamentally, taxpayers should not be forced to jump through

Newfound/Owatonna, Inc. v. Town of Harrison, 520 U.S. 564 (1997) (reduction of state property tax exemption for charities operated principally for the benefit of nonresidents is facially discriminatory and thus invalid); *Philadelphia v. New Jersey*, 437 U.S. 617 (1978) (New Jersey law banning waste imported from other States violates the Commerce Clause).

⁹ Indeed, even assuming that it would be constitutionally permissible to require taxpayers to establish a separate subsidiary in every State, that option might not be available to some businesses. For example, a transportation company whose assets and employees move across state lines would find it impossible to operate in interstate commerce through a series of domesticated subsidiaries.

¹⁰ In *Container Corp.*, the Court explained that an apportionment formula will offend the Commerce Clause unless it is marked by "internal consistency"—that is to say, unless it is such that "if applied by every jurisdiction, it would result in no more than all of the unitary business' income being taxed." 463 U.S. at 169. The California taxing scheme fails this test because, if other States adopted similar rules, more than 100 percent of Petitioner's income would be taxed.

the hoop of domesticating their business activities or establishing subsidiaries in every State in order to avoid discrimination. See *Kraft General Foods, Inc. v. Iowa Department of Revenue & Finance*, 505 U.S. 71, 78 (1992). Because the Commerce Clause does not afford States leeway to discriminate, the California statute must fall.

III.

The Constitution sets a limit on the power of a single State to tax the multistate income of a nondomiciliary corporation. A minimal connection between the interstate activities and the taxing State is required, as is a rational relationship between the income attributed to the taxing State and the intrastate value of the corporate business. *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 772-73 (1992); *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 328 (1982). The Due Process Clause requires that "there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax." *Allied-Signal*, 504 U.S. at 778. In other words, "[o]ne may not be subjected to greater burdens upon his taxable property solely because he owns some that is free." *National Life Ins. Co. v. United States*, 277 U.S. 508, 519 (1928).

In this case, the State of California does not assert that the taxpayer's non-business income bears any relation to its in-state activities. (App. at 16a ("all of the nonbusiness dividends were not taxable by the State of California").) Nor does the State assert a relationship of any great moment between that nontaxable, non-business income and the taxpayer's interest expense. Rather, the State seeks to tax Petitioner Hunt-Wesson's extraterritorial activities by requiring a dollar-for-dollar offset of constitutionally protected income against interest expense. See *Willamette Indus., Inc. v. Franchise Tax Board*, 39 Cal.

Rptr. 2d 757, 760-61 (Ct. App. 1995) (the tax is "exactly the same amount" whether nontaxable dividends are treated as taxable income or are applied against interest expense). Such taxing legerdemain—seeking to do indirectly what it cannot do directly—must not stand.

Under *Allied-Signal*, a State may tax dividend income *only* where the payee and payer of the dividend are engaged in a unitary business or the capital transaction serves an operational—rather than an investment—function. 504 U.S. at 787. Here, the State seeks to rationalize its taxation of dividend income by claiming it is closing a so-called loophole, *i.e.*, that a foreign corporation should not be permitted to borrow money and build up its interest expense deduction and then receive tax-exempt dividends on the basis of investments made with the borrowed money. *Pacific Telephone*, 7 Cal. 3d at 554. A suspiciously similar argument was advanced by the State of New Jersey in the *Allied-Signal* case. There, in seeking to repudiate the unitary business principle, the State argued that multistate corporations regard all their holdings as asset pools and therefore any distinction between operational and investment assets is artificial and should be ignored. 504 U.S. at 784-85. The Court wisely rejected this strained contention, noting instead that the relevant inquiry must focus on "the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State." *Id.* at 785. The dividend income sought to be taxed here bears no relationship to Petitioner's in-state activities and thus California's contrived attempt to tax it should be rejected as violating due process.

Moreover, the State's semantics—that the interest-offset rule is not a "tax" and therefore the precedents of this Court are not controlling—cannot change the substance of the statute. It is clear that California could not tax Petitioner's dividend income directly. *ASARCO Inc.*, 458

U.S. at 327-29. It is also clear that a State may not, through constitutional alchemy, indirectly tax income beyond its jurisdiction. In *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388 (1984), the Court clarified that the denial of a tax exemption (or a deduction) is the economic equivalent of a tax:

Nor is it relevant that New York discriminates against business carried on outside the State by disallowing a tax credit rather than by imposing a higher tax. The discriminatory economic effect of these two measures would be identical.

Id. at 404. See also *National Life Ins. Co.*, 277 U.S. at 520 ("What remains after subtracting all allowances is the thing really taxed.").¹¹ In other words, formal distinctions lacking in economic substance have no constitutional significance. *Westinghouse Electric Corp.*, 466 U.S. at 405. Thus, "[a] tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes." *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 374 (1991) (citation omitted). Cf. *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271, 282-83 (1924) (States' efforts to tax income from non-unitary entities is "a mere effort to reach profits earned elsewhere under the guise of legitimate taxation").

The State characterizes the interest-offset rule as a rational attempt to "correlate expenses between taxable and nontaxable income in order to determine the extent to which a deduction should be allowed." Brief of Franchise Tax Board in Opposition to Petition for Writ of

¹¹ *The Macallen Co. v. Massachusetts*, 279 U.S. 620, 629 (1929) ("The fact that a tax ostensibly laid upon a taxable subject is to be measured by the value of a non-taxable subject at once suggests the probability that it was the latter rather than the former that the law-maker sought to reach.").

Certiorari, *Hunt-Wesson, Inc. v. Franchise Tax Board*, No. 98-2043, at 16 (hereinafter cited as "Br. Op."). The State's argument conveniently ignores that non-business interest expense is deducted *before the interest-offset rule is applied*.¹² What is more, the statute makes no attempt to allocate the business interest expense to related income. Rather, it requires a dollar-for-dollar offset of the expense against non-business income, with no matching of expense to income being permitted.

That California's taxing scheme indirectly taxes constitutionally protected income cannot be denied. Consider the following example of the effect of the law on in-state and out-of-state companies:

Example 1. Parent (P), domiciled in Illinois with a non-unitary subsidiary (Sub A), does business in California. P has business income of \$200, business interest expense of \$150, non-business interest expense of \$25, and no business interest income. Sub A pays no dividends to P.

The \$25 in non-business interest expense is excluded, since none of that expense is deductible in California.¹³ The \$150 in business interest expense is deducted from the \$200 in business income. Thus, P's income subject to apportionment by California is \$50.

¹² In opposing the Court's review of the decision below, the State claimed (Br. Op. 17 n.9) that nothing in the statute requires the elimination of non-business interest expense as part of the calculation of the interest expense deduction. The State stipulated, however, that the interest-offset rule applies only to business interest expenses after the deduction of non-business interest. Stip. ¶ 11. The form used to calculate the offset is consistent with this stipulation. See Form 100 (California Corporation Franchise or Income Tax Return), Schedule R-5 (Computation of Interest Offset).

¹³ Non-business interest expense is allocated entirely to the state of domicile, in this example, to Illinois.

Now consider what happens to P's apportionable income if P receives dividend income:

Example 2. Assume the same facts in Example 1, except that Sub A pays to P a \$100 dividend. Because Sub A is not a unitary business with P, the dividend is non-business income, and because P is domiciled in Illinois, the \$100 is allocated entirely to that State and is not subject to California tax.

The \$25 in non-business interest expense is still excluded, since none of that expense is deductible in California. The \$150 in business interest expense, however, is now offset against the \$100 dividend, leaving only a deduction of \$50. Hence, only \$50 is subtracted from P's \$200 in business income, thereby increasing P's income apportionable by California to \$150.

As P receives non-business income—income indisputably immune from California taxation by virtue of the Commerce Clause—its California tax liability should not change. Instead, under California law, P's tax base subject to apportionment actually *increases*—an increase solely attributable to the effect of the interest-offset rule. By linking the interest deduction to the receipt of non-taxable dividends, California indirectly exacts a tax on the non-business income of out-of-state corporations.

The State of California asserts (in its brief in opposition) that the interest-offset rule is necessary to close a "loophole" and prevent taxpayers from realizing a "windfall." (Br. Op. 11-12.) The argument that the Constitution creates a loophole speaks volumes about the State's motivation here, for the interest-offset rule was designed to yield an impermissible windfall *to the State*, without regard to whether it resulted in double taxation. Consider the following example:

Example 3. P, domiciled in Illinois, does business equally in that State and in California. P has a total net income of \$125, computed, as follows: \$200 business income, \$100 non-business dividend income, \$150 business interest expense, and \$25 non-business interest expense. P is taxed on this income, as follows:

	California	Illinois
Business Income	\$200	\$200
Business Interest Expense	(150)	(150)
Interest Offset	100	0
Apportionable Income	\$150	\$ 50
Apportionment %	50%	50%
Taxable Business Income	<u>\$75</u>	<u>\$25</u>
Non-business Div. Income	0	\$100
Non-business Interest Exp.	<u>0</u>	<u>(25)</u>
Taxable Non-business Inc.	<u>0</u>	<u>\$75</u>
Aggregate Net Taxable Income	<u>\$75</u>	<u>\$100</u>

Thus, as a result of California's interest offset, P is taxed on \$175 of income, rather than its net income of \$125; \$50 in income is therefore subject to double taxation.

In *Allied-Signal*, the Court vivified the "necessary limit on the States' authority to tax value or income that cannot in fairness be attributed to the taxpayer's activities within the State." 504 U.S. at 780. "[Acting] as a defense against state taxes which, whether by design or inadvertence, . . . attempt to capture tax revenues that, under the theory of the tax, belong of right to other jurisdictions," *Trinova Corp.*, 498 U.S. at 386, the Court must suspend its disbelief about the true effect of California's taxing

scheme here. It is to impose an unconstitutional burden on Petitioner Hunt-Wesson and similarly situated taxpayers.

The State's attempt to reach Petitioner's nontaxable income by reducing its interest expense has the same effect as a direct tax on that income and cannot in fairness be sustained. The Court of Appeal did not dispute this. Indeed, while rejecting Petitioner's challenge on *stare decisis* grounds, the court below observed that "[i]f we were writing on a clean slate, these arguments might appear persuasive." (App. at 8a.) The court's reliance on the manifestly erroneous decision in *Pacific Telephone*, however, was clearly misplaced. See *United States v. Gaudin*, 515 U.S. at 521. This Court can correct the error by wiping the slate clean and striking down the interest-offset rule because it violates the Due Process Clause of the Constitution.

CONCLUSION

For the foregoing reasons, the Court should reverse the decision below.

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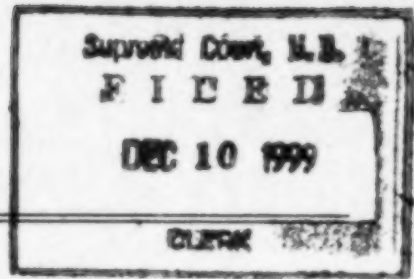
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November 10, 1999

DEC 10 1999

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No. 98-2043



In The
Supreme Court of the United States

HUNT-WESSON, INC.,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Writ Of Certiorari
To The Court Of Appeal Of California
For The First Appellate District

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STATES OF IDAHO, ALASKA, MONTANA, AND
NORTH DAKOTA IN SUPPORT OF RESPONDENT

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I. INTEREST OF AMICI CURIAE

This brief is submitted by the State of Idaho as *amicus curiae* in support of the respondent in *Hunt-Wesson, Inc. v. Franchise Tax Board*. Other States join this brief as *amici* to preserve the flexibility and diversity of practice they now enjoy in assigning interest expense to nonbusiness income.

Idaho also has a special interest in this case. Until 1998, Idaho had a statute, similar but not identical to California's Rev. & Tax. C. § 24344(b), that provided for an offset of interest expense against nonbusiness income.¹

¹ Former Idaho Code § 63-3022(a)(2) provided:

In the case of a corporation whose Idaho taxable income is computed pursuant to section 63-3027, Idaho Code, the interest expense deductible shall be an amount equal to interest and dividend income subject to apportionment, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income not subject to apportionment. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income not subject to apportionment. This provision shall not apply to dividend income excluded pursuant to section 63-3027C(c) and (e), Idaho Code.

As used in the quoted statute, income subject to apportionment is business income; income not subject to apportionment is nonbusiness income. The first cross-reference, to § 63-3027, refers to combined reporting and the Idaho version of the Uniform Division of Income for Tax Purposes Act (UDITPA), so that the quoted statute applies to single corporations and unitary corporate groups that operate in more than one state. The final cross-reference, to § 63-3027C, refers to a "water's edge" election, whereby a corporation can elect not to be taxed

The Idaho provision was repealed, effective January 1, 1998.² There is now pending in the Idaho Supreme Court a case in which, *inter alia*, Union Pacific Corporation challenges the constitutionality of Idaho's former statute.³ This Court's decision in this matter will substantially affect the outcome of the Idaho litigation on that issue.

Effective January 1, 1998, the Idaho Code was amended by adding new language that requires "related expenses" to be offset against nonbusiness income.⁴ For 1998 and later years, Idaho joins the other State *amici* in their common interest in retaining flexibility to assign

on certain income from foreign sources. The inapplicability of interest offset to such excluded foreign income is not an issue in *Hunt-Wesson*.

² H.B. No. 541, 1998 Sess. Laws, ch. 42, § 2, p. 176.

³ *Union Pacific Corp. v. Idaho State Tax Comm.*, No. CV OC 97104812D (4th Dist., Ada County, judgment entered Aug. 11, 1999), docketed as Nos. 25876 & 25882 (Idaho Sup. Ct., State's appeal filed Sept. 21, 1999 and Union Pacific's appeal filed Oct. 6, 1999).

⁴ The new language added at the end of Idaho Code § 63-3027(d) provides:

Allocable nonbusiness income shall be limited to the total nonbusiness income received which is in excess of any related expenses which have been allowed as a deduction during the taxable year. In the case of allocable nonbusiness interest or dividends, related expenses include interest on indebtedness incurred or continued to purchase or carry assets on which the interest or dividends are nonbusiness income.

The language was added by H.B. No. 541, 1998 Sess. Laws, ch. 42, § 5, p. 182.

interest expense to nonbusiness income free from a constitutional prohibition of any specific formula.

II. SUMMARY OF ARGUMENT

In Cal. Rev. & Tax. C. § 24344(b), for the purpose of assigning a corporation's interest expense to nonbusiness dividend and interest income, California classifies recipients of dividends based on whether they use debt or equity to finance their passive, nonbusiness investments. California allows interest expense to be deducted first against business interest income, and later against all other business income; but in between these layers of deduction, it requires that nonbusiness dividend and interest income be assigned a share of the taxpayer's interest expense.

Petitioner concedes that it would not raise constitutional challenges if California assigned interest expense to nonbusiness dividends using an unspecified formula, such as those used by the Internal Revenue Service and various states, that petitioner considers "fair." Petitioner thus impliedly agrees that its nonbusiness dividends bear an economic relation to its interest expense. But petitioner objects to California's particular assignment method. The dispute therefore is over exactly how to associate the expense with the income.

In the apportionment formula area, this Court has refrained from mandating or prohibiting any particular apportionment formula under the Constitution. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978); *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983). There is

no single correct way to assign interest expense to non-business income. It is the lack of uniformity – in particular, Illinois' lack of an interest offset statute – that is the cause of petitioner's grievance. The Court should leave the allocation of interest to the states just as it leaves apportionment formulas to the states, except in the rare case where the result is grossly distorted. *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931).

Money used to fund nonbusiness investments is fungible with operating funds. Applying the tests of fairness of apportionment formulas laid down in *Container Corp., supra*, California's formula based on fungibility reflects a reasonable sense of how petitioner's interest and dividend income is generated, and is therefore externally consistent. California's formula is also internally consistent because if Illinois adopted California's provision, petitioner's income would only be taxed once.

Expenses are typically not susceptible of precise division, either among taxing states (which makes separate accounting for net income impracticable) or among entities in a unitary group (when the expenses are part of unitary contributions to value), let alone among different streams of income received by a corporation. This Court permits a state to treat an expense that occurs only outside its borders as an expense of earning unitary income and as apportionable to the state. The state in such a case may deny a deduction for the out-of-state expense in a nondiscriminatory manner. *Amerada Hess Corp. v. Director, Div. of Tax.*, 490 U.S. 66 (1989). If a deduction can be denied, then it can also be reassigned to a different class of income, as here.

Refuting petitioner's first discrimination claim, § 24344(b) is neutral on its face and makes no mention of a corporation's domicile. Petitioner has shown no discriminatory intent on California's part. The classification in § 24344(b) is based on debt financing, which is unrelated to location, and nonbusiness income, which can arise anywhere. *Amerada Hess, supra*. There is no facial discrimination.

Petitioner's second claim of discrimination is based on the cross-reference in § 24344(b) to Cal. Rev. & Tax. C. § 24402, which excludes from the recipient's gross income dividends paid from income previously subject to California franchise tax in the hands of the paying corporation. Since the constitutionality of § 24402 is not directly in issue here, this Court should refrain from passing on it until the California courts have had an opportunity to interpret § 24402 in the first instance. In any event, § 24402 is narrowly tailored to prevent double taxation by California, which is a legitimate state objective not passed upon in the superficially similar case of *Kraft General Foods, Inc. v. Iowa Dep't of Rev. & Fin.*, 505 U.S. 71 (1992). And unlike the facts of *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), § 24402 coordinates the burdens of a single tax – the California franchise tax – and not two taxes on different bases, which was the case in *Fulton*. Section 24402 is a valid compensating tax.

The interest offset under § 24344(b) is inapplicable to dividends that are paid from income previously taxed by California in the hands of the dividend paying company. But the favorable treatment of such dividends in § 24344(b) is offset or cured by Cal. Rev. & Tax. C.

§ 24425, which provides for an offset of related or attributable interest against income excluded from the franchise tax. Read together with § 24425, § 24344(b) is neutral as between dividends from previously taxed California income and dividends from other income.

III. ARGUMENT

A. As with apportionment formulas, the Court should not "constitutionalize" a particular method of assigning interest expense

Petitioner questions the power of a taxing state to reclassify a deduction claimed by a unitary business for expenses. The problem can be analogized to the treatment in this Court's cases either of apportionment formulas or apportionability of items of income.

The unitary business principle and formula apportionment are two aspects of the principle that "a State may not tax value earned outside its borders." *ASARCO, Inc. v. Idaho St. Tax Comm.*, 458 U.S. 307, 315 (1982); *Container Corp.*, 463 U.S. at 164. Petitioner argues that California by § 24344(b) effectively taxes income that lies outside California's taxing power, (Pet. Br. 18), and that is "taxable by Illinois." (Stip. ¶ 8 (J.A. 19); J.A. 55 n. 3 (Court of Appeal opinion))⁵ There is an analogy between a

⁵ Petitioner carefully refrains from asserting that the dividends were actually taxed in full as nonbusiness income by petitioner's domicile state of Illinois. There is no evidence that petitioner actually reported the dividends as nonbusiness income in its Illinois tax returns.

formula to assign interest expense to income in arriving at net income and a formula to apportion net income among the states. This Court's three major cases on apportionment shed light on the interest formula question.

The first of these is *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931). There, a company manufactured goods in North Carolina, which used a single-factor apportionment formula consisting of the ratio of in-state property to total property, resulting in a North Carolina ratio of 83%. All of Hans Rees' output was sold through a New York office and warehouse to customers worldwide. Hans Rees put in evidence a separate accounting that showed that 17% of its income was earned in North Carolina. This Court struck down the North Carolina formula as applied to Hans Rees, holding that it was "unreasonable and arbitrary" in application "in attributing to North Carolina a percentage of income out of all appropriate proportion to the business transacted by the appellant in that State." 283 U.S. at 133 & 135.

The second case was *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978), involving a converse factual situation from *Hans Rees*. Moorman's factory was in Illinois, which used the three-factor formula of property, payroll and sales. Moorman sold about 20% of its output across the state line in Iowa, which employed a single-factor formula consisting of the ratio of Iowa sales to total sales. Moorman challenged the Iowa formula, alleging that Iowa was taxing Illinois income. This Court upheld the Iowa formula, noting the lack of a separate accounting of "actual income in Iowa" (437 U.S. at 275 n.9). The Court stated:

[W]e do not know whether Illinois and Iowa together imposed a tax on more than 100% of the relevant net income. . . .

Even assuming some overlap, we could not accept appellant's argument that Iowa, rather than Illinois, was necessarily at fault in a constitutional sense. It is, of course, true that if Iowa had used Illinois' three-factor formula, a risk of duplication in the figures computed by the two States might have been avoided. But the same would be true had Illinois used the Iowa formula. . . .

. . . The asserted constitutional flaw in [Iowa's] formula is that it is different from [the three factor formula] presently employed by a majority of States and that difference creates a risk of duplicative taxation. But a host of other division-of-income problems create precisely the same risk and would similarly rise to constitutional proportions.

Thus, it would be necessary for this Court to prescribe a uniform definition of each category in the three-factor formula. . . . A similar risk of multiple taxation is created by the diversity among the States in the attribution of "non-business" income. . . .

The prevention of duplicative taxation, therefore, would require national uniform rules for the division of income. . . . The Constitution, however, is neutral with respect to the content of any uniform rule. If division-of-income problems were to be constitutionalized, therefore, they would have to be resolved in the manner suggested by appellant for resolution of formula diversity – the prevalent practice would be endorsed as the constitutional rule. . . .

437 U.S. at 276-279 (footnotes omitted). (The third case in the series is *Container Corp.*, *supra*, discussed below in subheading D.)

Petitioner here asks the Court to partially "constitutionalize" the interest allocation issue by prohibiting California's particular formula. Petitioner's brief in the Court of Appeal in hypothetical examples alleged the double taxation of nonbusiness dividends by both Illinois and California.⁶ But petitioner has never made such a factual assertion, and carefully couched its double taxation argument in hypothetical terms only. Like *Moorman*, petitioner has not shown that the nonbusiness dividends were in fact taxed twice.

Also as in *Moorman*, petitioner's challenge would be moot if Illinois had an identical law, for then the interest expense would be allocated by both states to only one state – Illinois – and petitioner would retain the full benefit of its interest deduction. As in *Moorman*, the constitutional fault, if there is one, may be laid either at California's door or those of the other states. This Court can grant the relief requested only by "constitutionalizing" one or more of the formulae that petitioner characterizes as "fair." Just as this Court refused to "constitutionalize" a particular apportionment formula in *Moorman*, the Court should refuse to do so here. The Constitution does not require or prohibit any particular formula to assign interest expense to nonbusiness dividends.

⁶ Respondent's Reply Brief, p. 12, in the California Court of Appeal (March 18, 1998).

On the other hand, taxpayers should be protected from an assignment of interest expense "out of all appropriate proportion" to the nonbusiness income, *Hans Rees*, 283 U.S. at 135, or an assignment that leads to "a grossly distorted result," *Norfolk & Western R. Co. v. State Tax Comm'n*, 390 U.S. 317, 326 (1968). The petitioner has offered no such evidence in this case.

B. Petitioner's interest expense is related to the nonbusiness dividends because the loan proceeds freed up equity capital for nonbusiness investments

Conceptually, the possible degrees of relationship between petitioner's interest expense and its nonbusiness dividends can be arranged in a hierarchy or continuum of relatedness, from direct traceability to complete lack of connection. The relationship between interest expense and dividend income here at issue falls between the two poles of relatedness.

- *Not a purchase money borrowing.* The hierarchy starts with a direct link between the interest expense and the dividend income. There is no evidence in the record that Beatrice borrowed money specifically to acquire or hold one or more of the dividend paying subsidiaries. Nor is there evidence that the debt was used for any other narrow purpose. The debt is therefore unlike an individual's purchase money mortgage secured by a home. It also differs from the leveraged buyout situation, where a target company's assets are pledged to secure the acquirer's borrowing.

As will become clearer as we proceed along the continuum, the lack of a direct connection does not mean that the interest expense and the dividend income are completely unrelated to each other.

- *No "direct tracing."* Beatrice did not make direct operating loans to its foreign subsidiaries. Each foreign subsidiary was directly responsible for its own borrowings. (Stip. ¶ 9 (J.A. 19)) The monies borrowed by Beatrice were not passed through to the foreign subsidiaries to fund their current operations or borrowings.

- *Fungibility, part I: Indirect relationship subject to proration by formula.* The stipulated facts do not show a direct relationship of petitioner's interest expense to any particular income. Petitioner's brief states that "none of that interest expense bore any *direct* relationship to the production of the exempt income." (Pet. Br. 20, emphasis added) Petitioner's careful phrasing must mean that there is an "indirect" relationship.

Since no direct tracing is possible, California could have attempted to apply what petitioner refers to as "reasonable methods of fairly allocating interest expense between various classes of income." (Pet. Br. 27) Petitioner admits that had a formula allocation of interest expense been applied, then "petitioner would not be here." (Pet. Br. 23) Petitioner thus concedes an "indirect" relationship between the interest expense and the dividend income, sufficient to support an unspecified formulaic allocation of the one to the other.

- *Fungibility, part II: Interest offset based on fungibility of cash.* In support of § 24344(b), the California Supreme Court suggested that a corporation's money is fungible,

so its funds from all sources contribute to all of its activities:

[O]therwise there may be a loophole. A foreign corporation could avoid all taxes in California merely by increasing its borrowing to create an interest deduction and then purchasing stocks which pay dividends.

Pacific Tel. & Tel. Co. v. Franchise Tax Bd., 7 Cal. 3d 544, 554, 498 P.2d 1030, 1037 (1972). The broader theory of the California Supreme Court is that borrowed money and equity capital are fungible with each other.

The Constitution should permit a state to associate interest expense with dividend income if the fungibility of money permits the inference that borrowed money was substituted for equity and used for business purposes, freeing up the taxpayer's equity capital for nonbusiness investments. More will be said about this theory below, after discussing the last rung of the hierarchy of relationships.

- *The straw man position: Zero relationship, with no assignment of interest expense.* Petitioner argues repeatedly that there is no relationship whatever between the interest expense and the nonbusiness dividends.⁷ Despite petitioner's protestations, this "zero" level of relationship is not the fact pattern before us now.

⁷ E.g., Pet. Br. i ("unrelated"), 2 ("no relationship"), 14 (no "purported relationship"), 16 ("facts do not reveal any relationship"), etc.

The trial court stated:

[I]t appears that no portion of the interest expense deduction can be attributable to the generation of the . . . exempt dividends, [because] no portion of the proceeds of the loans generating the interest expense deductions herein went to any non-unitary corporation. . . .

(J.A. 45) The trial judge evidently made his "no attribution" finding using a "direct tracing" standard. But he did not consider, let alone consider and dismiss, possible standards of indirect relatedness based on either proration by formula or fungibility of cash. The Court of Appeal reversed, based on the California Supreme Court's *Pacific* decision, which used a fungibility rationale.

Petitioner concedes some degree of relationship between the interest expense and the dividend income. Petitioner admits it would accept a "fair," "reasonable" allocation of interest expense to the dividend income; this "would obviate the constitutional issues raised by this case." (Pet. Br. 26) There is no reason for petitioner to accept a formula allocation if there is in fact zero relation between the interest expense and the dividend income. Petitioner's acceptance of a formula allocation is an admission *sub silentio* that the dividend income and the interest expense are rationally connected.

The bottom of the hierarchy – the complete absence of a relationship between the interest and the dividends – is not the case before us. *National Life Ins. Co. v. U.S.*, 277 U.S. 508 (1928) is not on point. The posture of "zero relationship" diverts attention from the real issues.

Fungibility is a useful analytical model because credit gives individuals and businesses financial flexibility they would not otherwise have. This is true even where the use of borrowings can be traced to specific purchases. In the case of individuals, if there were no home mortgages, the amount of money invested by individuals in today's stock market would be dramatically reduced. Equity savings freed up by home lending become available to be invested elsewhere.

All publicly traded companies are required by the Securities and Exchange Commission (SEC) to publish, in their annual reports, financial statements including a statement of cash flows.⁸ A cash flow statement accounts for all increases and decreases in the cash of the corporation during the year. Operating, financing, and investing cash flows are grouped together, and a single bottom line shows the net increase or decrease in cash. The cash flow statement graphically illustrates that cash is fungible and passes freely between business and nonbusiness uses. The fungibility of cash is a reality of the business world.

C. The difficulty of tracing expenses underlies both the unitary business principle and California's ordering formula

After apportionment formulas, a major concern of this Court's unitary tax jurisprudence is the apportionability of dividend income. Dividend income can be

⁸ 17 C.F.R. §§ 210.3-02 & .12-04 (1999). Annual reports are available from the SEC, on companies' Web sites, and in most public libraries.

apportioned to a taxing state only if the dividend income is either part of the taxpayer's unitary business conducted in the taxing state or is earned in an operational function of the taxpayer. *Allied-Signal, Inc. v. Director, Div. of Tax.*, 504 U.S. 768, 787 (1992). One might invert that principle and hold that a state is obliged to allow a deduction for an expense incurred in the course of the unitary business or in an operational function, but not for other (nonbusiness) expenses. But applying such a rule to interest expense requires some form of tracing of the use of borrowed funds. Unlike an item of receipts, the origin of which is traceable to a specific outside customer or investment asset, funds used to pay expenses are commingled with the fungible cash of the business. Tracing them requires the use of one or more assumptions, the choice of which is usually arbitrary.⁹

Expense allocation is one reason for "the impossibility of allocating specifically the profits earned by the processes conducted within [a state's] borders," *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 121 (1920). The difficulty of tracing the impact on each store's expenses of a centralized purchasing operation underlay the early unitary case of *Butler Bros. v. McCollgan*, 315 U.S. 501 (1942). Common expenses are a hallmark of a unitary business, and a major reason for adopting the unitary business principle in the first place. Here, to attempt to assign expenses to specific items of income within a

⁹ Compare the calculation of the cost of goods sold by a business, using an assumption that fungible goods in a commingled inventory are sold in a particular order, such as first-in, first-out or last-in, first-out.

unitary business would invite problems similar to those of separate accounting within state borders.

This Court has stated that even when an expense can be traced to an activity that occurs only outside the taxing state, if the expense is a cost of producing unitary income, a taxing state may constitutionally treat it as an in-state expense, deny a deduction for it, and apportion the resulting net income. *Amerada Hess Corp. v. Director, Div. of Tax.*, 490 U.S. 66 (1989). Here, conversely, even if petitioner were correct in tracing the interest expense exclusively to business income, California may reclassify the deduction in a nondiscriminatory manner by assigning it to nonbusiness income.

Given the business reality that borrowed funds are fungible with equity funds, California first allows a deduction for interest expense to the extent of apportionable business interest income.¹⁰ Only then is fungible interest expense applied against nonbusiness interest and dividend income.¹¹ Finally, all remaining interest is deducted from all other apportionable business income.¹² California's three-tiered approach is supported by this Court's decisions.

¹⁰ Amounts in this first layer of deductions are shown at Pet. Br. 10.

¹¹ Amounts in the second layer are at Pet. Br. 11, carryover paragraph.

¹² Amounts in the third layer are shown in Pet. Br. 11, n. 11.

D. The California formula based on fungibility reflects a reasonable sense of how petitioner's income is generated and is externally consistent

Returning to this Court's cases on apportionment formulas, we consider *Container Corp.*, *supra*. Container, a multinational manufacturer, asserted *inter alia* that its property and payroll in foreign countries were more productive than those in California, hence California's use of raw property and payroll figures in the apportionment formula overstated Container's California income. The Court denied relief, holding that California's formula, while "necessarily imperfect," was

certainly within the substantial margin of error inherent in any method of attributing income among the components of a unitary business.

463 U.S. at 183 (citations omitted). The assignment of interest expense to dividend income is a step in the process of "attributing income among the components of a unitary business" and should be subjected to the same level of constitutional scrutiny as an apportionment formula.

Container laid down two tests of fairness of an apportionment formula under the Due Process and Commerce Clauses:

The first . . . component of fairness in an apportionment formula is what might be called internal consistency – that is the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business's income being taxed. The second and more difficult requirement is what might be called external consistency – the factor or factors

used in the apportionment formula must actually reflect a reasonable sense of how income is generated. . . .

463 U.S. at 169.

As to external consistency, the Court evidently was more comfortable with a three-factor formula of property, payroll and sales than it was with the single-factor property formula in *Hans Rees*. The Court found single-factor formulas to be

particularly problematic because they focus on only a small part of the spectrum of activities by which value is generated. . . .

On the other hand, the three-factor formula

has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated. . . .

463 U.S. at 182-183.

Applying this analytical structure to the present case, petitioner's willingness to accept an unspecified, "fair" formula method in effect concedes that money is fungible. The fungibility of money reflects a reasonable consensus about how income is generated. Taking it a step further, it is reasonable to equate passive, recurring income such as dividends and interest with the regular expense of interest, as the California Supreme Court did. *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 7 Cal. 3d 544, 555, 498 P.2d 1030, 1038 (1972). A taxpayer can normally be expected to use its dividend and interest income to defray its interest expense. From a cash flow perspective,

the receipts go into a single "pot" and the interest is paid from that "pot."

California's tiered system of assigning interest expense in sequence, first to business interest income, then to nonbusiness income, and lastly to other business income, reflects a reasonable sense of how income is generated. It is externally consistent.

E. California's interest offset statute is internally consistent

Even if § 24344(b) causes petitioner effectively to lose the California tax benefit of its nonbusiness income, if petitioner's domicile state of Illinois were to adopt an equivalent of § 24344(b) (or if petitioner were domiciled in Idaho, which had such an equivalent during the tax years in dispute here), then petitioner would gain a tax benefit in Illinois (or Idaho) equivalent to that lost in California. Internal consistency requires nothing more. The California statute is internally consistent.

F. California's interest offset statute (without regard to the parenthetical exception for dividends from previously taxed income) is facially neutral

In its part II, petitioner raises two challenges to § 24344(b) alleging discrimination. The first challenge is that § 24344(b) discriminates against interstate commerce by denying interest deductions only to nondomiciliary corporations.

Section 24344(b) on its face does not mention a corporation's domicile. In this respect, it resembles the New Jersey statute that this Court upheld in *Amerada Hess Corp.*, *supra*. There, New Jersey's corporate income tax statute disallowed a deduction for "[t]axes paid or accrued to the United States on or measured by profits or income," which denial was held by the New Jersey Supreme Court to extend to the federal Crude Oil Windfall Profit Tax. Although no oil is produced in New Jersey, this Court found that the statute was not facially discriminatory, since it also denied a deduction for the federal income tax. 490 U.S. at 76-77. The Court stated:

[I]n the absence of discriminatory intent or a statute directed specifically at economic activity that occurs only in a particular location . . . , a deduction denial does not unduly burden interstate commerce just because the deduction denied relates to an economic activity performed outside the taxing State.

490 U.S. at 78 n.10 (citation omitted). Here, petitioner cites no evidence of discriminatory intent on California's part. Nonbusiness income, like the expense of the federal income tax, can arise anywhere, without geographic limitation. Without regard to the parenthetical language that cross-refers to § 24402 (discussed in subheadings H, I, and J below), the California statute is facially neutral.

G. California's interest offset statute (without regard to the parenthetical exception for dividends from previously taxed income) does not discriminate in practical operation

Petitioner also sees discrimination in the practical effect of the statute. This Court's apportionment formula cases again furnish a helpful analogy. In *Moorman*, *supra*, Iowa employed an apportionment formula consisting of the ratio of Iowa sales to total sales, while most other states, including Moorman's home state of Illinois, employed the three-factor formula of property, payroll, and sales.

On that fact pattern, suppose two companies otherwise equally situated, as follows: Company A is Moorman, with its factory and offices in Illinois, selling primarily into states other than Illinois, including Iowa. Company B is Moorman's hypothetical competitor, but with its factory and offices in Iowa and selling primarily into states other than Iowa, including Illinois.

Because Illinois employs property and payroll in its formula, its law will attract more Illinois tax to Illinois-based companies than to similarly situated companies not based in Illinois. Illinois' three-factor formula disadvantages locally based companies; it disadvantages Moorman compared to Company B. Conversely, Iowa's formula disregards headquarters and plant that would be represented by property and payroll. Iowa bases its apportionment only on sales. Company B, primarily an exporter from Iowa, will pay less tax in Iowa than Moorman, a nondomiciliary company selling into Iowa. The Iowa law advantages local companies and disadvantages out-of-

state companies. Any company whose sales are primarily outside its home state will have an incentive to locate its plant and headquarters in Iowa as opposed to a three-factor state. This is a differential treatment in practical effect. Yet this Court in *Moorman* sustained Iowa's formula, holding that any discrimination was a consequence of a lack of uniformity. 437 U.S. at 277 n.12.

California's statute is even more benign than that in *Moorman* because the classification here is based on how the taxpayer finances itself. The Commerce Clause is not violated when the differential tax treatment of two categories of companies "results solely from differences between the nature of their businesses, not from the location of their activities." *Amerada Hess*, 490 U.S. at 78 (citation omitted). A spillover effect of § 24344(b) on nondomiciliaries is a natural consequence of a classification based on debt financing of passive investments, just as the spillover effect of Iowa's apportionment formula is a natural consequence of a constitutionally acceptable variation in apportionment philosophy. Neither consequence is of constitutional dimension.

This Court has also stated that allegations of discrimination may be refuted by showing that the tax is fairly apportioned. The third (anti-discrimination) prong of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) "has not in practice required much in addition to the requirement of fair apportionment." *Container Corp.*, 463 U.S. at 171. Fair apportionment may offset and cure alleged discrimination. Petitioner has not challenged the apportionment formula applied by California. As argued

above, California's statute is both externally and internally consistent. There is therefore no discrimination cognizable by this Court in § 24344(b), without regard to the parenthetical language, to which we turn next.

H. The parenthetical exception to § 24344(b), for dividends from income previously taxed by California, is a narrowly tailored means to prevent double taxation

In part III of its brief, petitioner attacks § 24344(b) as discriminatory based on the parenthetical language reading, "(except dividends deductible under Section 24402)." Rev. & Tax. C. § 24402 allows a recipient a deduction for dividends declared from income that has been "included in the measure of the [California franchise] tax[]. . . ." ¹³ Since the constitutionality of § 24402 is not directly in issue here, this Court should refrain from passing on it until the California courts have had an opportunity to interpret § 24402 in the first instance.

• *Mechanics of § 24402.* To illustrate how § 24402 works, suppose Company S in year 1 has business income of \$100 and no nonbusiness income, and a California apportionment factor of 25%. Thus, \$25 of Company S's income is subject to California's franchise tax, and Company S pays that tax. On January 1 of Year 2, Company S pays \$40 in dividends to its shareholders.

¹³ Idaho's equivalent to California's § 24344(b) was former Idaho Code § 63-3022(a)(2), quoted in note 1, *supra*. Idaho has no equivalent to California's § 24402. Subheadings H, I, and J of this Argument are not applicable to Idaho.

Company P owns 10% of Company S and so receives \$4 in dividends. Company P is taxable in California. Without § 24402, Company P would report the \$4 as gross income in California. By application of § 24402, Company P may deduct up to \$1 of the dividend,¹⁴ reporting \$3 as income in California. The \$1 deduction adjusts for the tax that Company S paid on 25% of its pretax income in Year 1. California has already taxed Company S and so gives partial relief to Company P.

• § 24402 prevents double taxation. There are surface similarities between § 24402 and the Iowa provision held unconstitutional in *Kraft General Foods, Inc. v. Iowa Dep't of Rev. & Fin.*, 505 U.S. 71 (1992). That case, however, is not on point.

Kraft involved an Iowa income tax statute that allowed a deduction to a corporation for 100% of dividends received from subsidiaries that were incorporated in the United States and in which the payee corporation owned more than 80% of the stock. Iowa did not allow a similar deduction if the dividend payor was incorporated

¹⁴ The actual percentage of P corporation's allowable deduction will vary depending on how much stock P owns in S. If P owns more than 50% of S, then the deduction is 100% of the \$1; if 20% or more up to 50%, then the deduction is 80 cents (80% of the \$1); if less than 20%, the deduction is 70 cents (70% of \$1). The stepped-down percentages were presumably borrowed from Internal Revenue Code § 243. As the stepped-down percentages do not affect the constitutional analysis so far as your *amici* are aware, the example in the text assumes that P gets a deduction of \$1.

in a foreign country. This Court struck down the Iowa deduction as facially discriminatory.

Iowa did not argue that its deduction was intended to prevent double Iowa taxation of the income of Kraft's domestic subsidiaries, and this Court did not pass on the question whether avoidance of such double taxation would be a justification sufficiently compelling to support the challenged statute.¹⁵ Here, unlike *Kraft*, the tax deduction is narrowly tailored to avoid double taxation by California. Avoidance of double taxation is a proper objective of state taxation, and your *amici* see no less burdensome means of achieving that objective.

I. The parenthetical exception to § 24344(b) is a valid compensatory tax

There is also a superficial resemblance between § 24402 and the North Carolina provision held unconstitutional in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996). But like *Kraft*, *Fulton* is not on point.

Fulton involved the North Carolina "intangibles" tax on the value of stock held by North Carolina resident shareholders. The challenged statute allowed a deduction of value from the tax base equal to the percentage of the issuing corporation's income that was subject to the North Carolina income tax. This Court struck the intangibles tax down as facially discriminatory. The Court found that the intangibles tax and the corporate income

¹⁵ The benefit of avoiding double taxation was alluded to only in the dissenting opinion of Rehnquist, C.J., 505 U.S. at 86.

tax were so different that the former could not be viewed as compensating for the latter. Even though the value of a corporation's stock might be directly affected by the amount of North Carolina income tax that the corporation paid, the burden of the two taxes fell on different classes of people (corporations versus shareholders), and their different rates (7.75% for income, .25% on value of stock) did not assure that out-of-state companies were subject to equal or lower tax overall than local companies. 505 U.S. at 337-340.

Unlike the provisions in *Fulton*, § 24402 coordinates the impact of the California corporate franchise tax (one tax as opposed to two in *Fulton*) between the dividend paying corporation and the recipient corporation. Section 24402 therefore should survive a facial challenge as a compensatory or complementary tax. *Associated Indus. of Mo. v. Lohman*, 511 U.S. 641 (1994).

Again, the constitutionality of § 24402 is not directly in issue here. The Court should refrain from passing on its constitutionality until the California courts have an opportunity to interpret it in light of current constitutional jurisprudence.

J. Even with the parenthetical exception included, § 24344(b) does not discriminate

An allegedly discriminatory tax provision must be evaluated in the context of the entire taxing system, for defects in one area may be offset or cured by other provisions. *Washington v. U.S.*, 460 U.S. 536, 542 (1983).

Returning to our hypothetical example, the parenthetical language in § 24344(b) removes the deducted \$1 portion of Company P's \$4 dividend from the § 24344(b) interest offset computation. Assuming the dividend from S is nonbusiness income to P, and that P has ample interest expense, then at least under § 24344(b) only \$3 of interest expense will be assigned to the S dividend, increasing P's apportionable income to that extent, while the excluded \$1 of the S dividend has no effect on P's apportionable income.

Petitioner looks at §§ 24402 and 24344(b) in isolation and sees a fatal discrimination, giving favorable treatment to the \$1. But the separate offset provision of § 24425 cures this problem. Section 24425 denies a deduction for

[a]ny amount otherwise allowable as a deduction which is allocable to . . . income not included in the measure of the tax.

By operation of § 24425, the \$1 portion of the dividend will also attract interest expense. To the extent there is interest expense directly traceable to the S dividend, or fairly associable with it by a formula method, then up to \$1 of interest expense will be applied to offset the excluded \$1. *Great Western Fin. Corp. v. Franchise Tax Bd.*, 4 Cal.3d 1, 479 P.2d 993 (1971). Thus, California offsets dividends from companies having income taxed by California equally with dividends from other companies. Sections 24344(b), 24402, and 24425, taken together, form a nondiscriminatory system.

—————◆—————

IV. CONCLUSION

Section 24344(b) passes constitutional muster. The decision of the California Court of Appeal should be affirmed.

Respectfully submitted,

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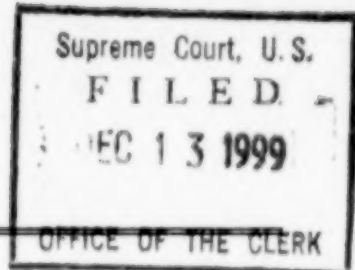
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No. 98-2043



IN THE
Supreme Court of the United States
OCTOBER TERM, 1999

HUNT-WESSON, INC.,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

**On Writ of Certiorari to the
Court of Appeal of California
For the First Appellate District**

**Brief Amicus Curiae of Multistate Tax
Commission In Support of Respondent**

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INTEREST OF AMICUS CURIAE¹

The Multistate Tax Commission is the administrative agency formed by the Multistate Tax Compact. RIA ALL STATES TAX GUIDE ¶ 701 et seq., p. 751 (1995) ("COMPACT"). The COMPACT was developed cooperatively by States and taxpayers in response to the criticisms and recommendations of the Willis Committee. See David Brunori, *Interview: Gene Corrigan, A 'Proud Parent' of the MTC*, 17 ST. TAX NOTES 1295 (1999).² The COMPACT seeks to resolve issues inherent in "Our Federalism." Federalism recognizes separate and independent state taxing authority with regard to multijurisdictional commerce as a legitimate source of revenue for the several States to discharge their sphere of governmental responsibility.

Twenty-one States (including the District of Columbia) have adopted the COMPACT as a part of their law. One State is a sovereign member, a class of membership that affords a full consultative opportunity without formal adoption of the COMPACT. Nineteen additional States have expressed

¹No counsel for any party authored this brief in whole or in part, although the brief was submitted to a staff member of the California Franchise Tax Board who made comments that were considered in preparation of this brief. Only *Amicus* Multistate Tax Commission and its members States made any monetary contribution to the preparation or submission of this brief. Finally, this brief is filed pursuant to the consent of the parties.

²The Willis Committee, a congressional study of state taxation of interstate commerce sanctioned by TITLE II of PUB. L. NO. 86-272, 73 STAT. 555, 556 (1959), made extensive recommendations as to how Congress could regulate state taxation of interstate commerce.

commitment to the Commission by joining as associate member States.³ This Court upheld the validity of the COMPACT in *United States Steel Corp. v. Multistate Tax Comm'n*, 434 U.S. 452 (1978).

The Commission appears here to defend the qualified sovereignty of the States to tax interstate and foreign commerce that the Court has indicated should pay its fair share of the cost of state government. *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298 (1994); *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959). A defense appears necessary, because there is rapid expansion of multijurisdictional commerce in the United States and the rest of the world. This change has the potential to influence the operation of state tax systems and their compliance with the U.S. Constitution. The Commission's interest in this context extends to preserving existing state tax systems when allegations of extra-territorial taxation and Commerce Clause discrimination arising from multijurisdictional commerce are not supported by the jurisprudence of the Court.

Given the diversity of approaches used by the several States to match interest expense with taxed

³The current full members are the States of Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Maine, Minnesota, Missouri, Michigan, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah, and Washington. The one sovereignty member is the State of Florida. The associate members are the States of Arizona, Connecticut, Georgia, Illinois, Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, New Hampshire, New Jersey, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, West Virginia, and Wisconsin.

and non-taxed income, the Commission is specifically concerned with Hunt-Wesson's inherent suggestion to "constitutionalize" a particular method or methods as best suited to accomplish that task. The Commission's concern is increased here given the potential for an unclear constitutional pronouncement that would be based upon a record the parties are interpreting differently. The Commission seeks to avoid an unnecessary constitutional pronouncement on an "important federal question," U.S. Sup. Ct. R. 10(c), that would largely rest upon a taxpayer's allegations of "foot faults" by the state tax administrator. We believe the Court can conclude upon the entire record that it is unnecessary to find the existence of a constitutional infirmity here.

Further, the Commission is also concerned that this case may encourage a cascade of cases that would attempt to find violation of the Commerce Clause merely because a litigant can identify some geographical element in the challenged state taxing rule. This risk is especially troublesome when, as here, the geographical element is attributable to a State's good faith attempt to wrestle with constitutional requirements. Differences in state taxing rules that have a geographical element should not be overplayed as being constitutionally significant.

Finally, the Commission seeks to avoid a Commerce Clause decision that would violate tax neutrality between in-state commerce and multi-jurisdictional commerce. Compare *Joseph v. Carter & Weeks Stevedoring Co.*, 330 U.S. 422 (1947), with *Dept. of Revenue v. Ass'n of Washington Stevedoring Cos.*, 435 U.S. 734 (1978) (eventual constitutional rule preserves neutrality). We think reasonable and protective Commerce Clause rules can be fashioned

without placing domestic commerce at a disadvantage. But see *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

SUMMARY OF ARGUMENT

The issues are simple. Does California's interest matching rule result in extra-territorial taxation. And does California's rule discriminate against [interstate and] foreign commerce. A further inherent question is whether the Constitution mandates any particular method of matching interest expenses with taxable and nontaxable income.

The issues arise because Hunt-Wesson erroneously insists that California first requires a total exclusion of nonbusiness interest expense before calculating the interest expense offset or reduction against nonbusiness dividend income. Hunt-Wesson also inappropriately contends that California has failed to meet a State's burden to prove that the excluded interest expense either was not related to business income or, alternatively, was related to nonbusiness dividend income. Examination of the entire record discloses that Hunt-Wesson has misinterpreted the evidence and has misapplied applicable constitutional doctrine.

California unequivocally states that the contested interest matching rule does not first require an exclusion of all nonbusiness interest expense. The tax form, Schedule R-5, relied upon by Hunt-Wesson to prove its case, was an error that has been corrected for this taxpayer and others. Further, Hunt-Wesson does not suggest it has been harmed by the erroneous tax form and its subsequent correction. After California's remedial action, there is little the Court could do to rectify this alleged constitutional misstep. See *Diffenderfer*

v. Central Baptist Church of Miami, Florida, 404 U.S. 412 (1972) (*per curiam*).

Similarly, the stipulations, a significant part of Hunt-Wesson's theory, fairly interpreted in light of the entire record, do not support the contention that the disallowed interest expense was attributable only to business income. Hunt-Wesson offers no other proof to this effect.

Hunt-Wesson's claim of indirect taxation of constitutionally exempt income, nonbusiness dividends, must fail, because the mechanical application of the matching rule in taxpayer's specific circumstance does not establish the matching rule's constitutional effect. California's matching rule does not offset against nonbusiness dividends unless the taxpayer has insufficient business interest income to swallow up the total interest expense without any regard to how the underlying indebtedness may have been used in the production of income. Also, the California rule does not require any reduction of the interest expense against nonbusiness dividend income, unless the taxpayer actually has such income. Therefore, under the California rule a taxpayer could have invested in nonbusiness assets without paying for those investments in the form of a reduction in the deduction of its interest expense.

Likewise there is no proof of taxation of extra-territorial income, because Hunt-Wesson (other than referring to stipulations that do not stand for their cited meaning) has not discharged its constitutional obligation to establish by clear and convincing evidence that the disallowed interest expense was related to extra-territorial income, the nonbusiness dividend income. In any event, Hunt-Wesson inappropriately seeks "to constitutionalize" the method States would have to employ to match

interest expense. This effort should be rebuffed, because there is no perfect method, all methods having their failures as is evidenced by the many diverse methods presently used by the States and the Federal Government to address this knotty problem. This kind of principle is better left to the legislative process in the absence of proof of systemic multiple taxation.

The matching rule does not violate the Commerce Clause. Hunt-Wesson did not rely on submitted evidence to support its premise that underlies this claim. By suggesting other "reasonable" matching methods, Hunt-Wesson admits debt capital is fungible and some portion of its interest expense was tied to the nonbusiness dividend income.

And there is no calculus available to establish that either domiciliaries were treated better or non-domiciliaries were treated worse. The matching rule applies without regard to the domicile of the taxpayer (no facial discrimination). The offset follows the character of the income received and not the residence of the taxpayer. Indeed, the California rule has the potential to treat nondomiciliaries quite favorably, better in some circumstances than the methods endorsed by Hunt-Wesson. And a domiciliary taxpayer faces a significant cost to securing more *deductibility* of its interest expense—full *taxability* of nonbusiness dividends. The absence of a calculus also follows from the uncertainty of ever knowing what one's tax attributes may be in the future. It would always remain a guess to change a domicile upon the desire to receive a *deduction* when the *tax cost* of having the deduction would necessarily remain unknown.

ARGUMENT

I. BEFORE EVALUATING THE CONSTITUTIONALITY OF CALIFORNIA'S RULE FOR MATCHING INTEREST EXPENSE TO DIVIDEND INCOME, THE COURT SHOULD REVIEW THE ENTIRETY OF THE RECORD TO UNDERSTAND HOW THE RULE OPERATES.

A. Introduction.

This is a simple case raising simple issues. Hunt-Wesson,⁴ a non-domiciliary of California, challenges the constitutionality of the California rule for matching deductible interest expense against business and nonbusiness dividend income. Hunt-Wesson asks: (1) Does California's interest expense matching rule result in extra-territorial taxation. Pet. Brief 18-33. And (2) is California's interest expense matching rule discriminatory, because it is applied without tying the reduction in the interest expense deduction to constitutionally exempt dividends? Pet. Brief 35 (first para.). This case further asks if the Due Process and Commerce Clauses of the Constitution require a State to use any particular method or methods to match interest expenses to dividend income.

The need of a State to match interest expense is obvious. Hunt-Wesson does not dispute this self-evident principle. Pet. Brief 23. Without a matching rule for interest expense, a savvy taxpayer is encouraged to engage in interest arbitrage to avoid tax in a State that may only tax constitutionally apportionable dividend income.

⁴ We use the name Hunt-Wesson interchangeably with its predecessor-in-interest, Beatrice Foods Company.

To illustrate, Corporation is commercially domiciled in State A. Corporation earns \$12 of apportionable income in State B. On advice of its tax professional, Corporation borrows \$200 from a lender at 6 percent per annum interest for use in the business. Corporation simultaneously invests a "different" \$200 in preferred stock with an annual dividend of 6 percent. The company issuing the preferred stock is totally unrelated to the unitary business being conducted in State B and the dividends are not therefore subject to tax by State B. Without an interest expense matching rule (whether by legislative choice or constitutional compulsion), State B will allow an interest deduction of \$12 that completely eliminates the apportionable income of \$12 in State B. Corporation has earned \$12 of apportionable income in State B and yet has paid no tax on that income.

B. A Description Of The California Matching Rule For Interest Expense When Taxpayer Receives Constitutionally Exempt Dividend Income.

The issues arise because the U.S. Constitution constrains the taxing jurisdiction of a State with regard to a multijurisdictional company that receives dividends not tied to the unitary business operating within the taxing State (nonbusiness dividend income). UDITPA harmonizes its division of income rules with this reality. See Uniform Division of Income for Tax Purposes Act ("UDITPA") §1(a) (business income defined), 7A UNIFORM LAWS ANNOTATED 331, 336 (WEST 1985), also codified in California at Cal. Rev. & Tax. Code § 25120(a) and as a part of the COMPACT at Cal. Rev. & Tax. Code § 38006. And see UDITPA §1(e) (nonbusiness in-

come defined), 7A UNIFORM LAWS ANNOTATED at 337, also codified as a part of California law at Cal. Rev. & Tax. Code § 25120(e) and as a part of the COMPACT at Cal. Rev. & Tax. Code § 38006. Business income is the state law (UDITPA) equivalent of income that may be subject to apportionment. Nonbusiness income is the state law (UDITPA) equivalent of income that may not be subject to apportionment. See *Allied-Signal, Inc. v. Director, Div. Of Taxation*, 504 U.S. 768, 786 (1992); Pet. Brief 5-6.)

Jurisdiction to tax nonunitary dividends depends upon the company's commercial domicile. Under UDITPA, reflecting this jurisdictional understanding, all unitary or business income of a multijurisdictional business is apportionable regardless of domicile and all nonunitary or nonbusiness income is allocable, with nonunitary or nonbusiness dividend income specifically being allocated to the State of commercial domicile. See UDITPA §9, 7A UNIFORM LAWS ANNOTATED at 348, also codified in California at Cal. Rev. & Tax. Code § 25128 and as a part of the COMPACT at Cal. Rev. & Tax. Code § 38006; UDITPA §7, 7A UNIFORM LAWS ANNOTATED at 346, also codified in California at Cal. Rev. & Tax. Code § 25126 and as a part of the COMPACT at Cal. Rev. & Tax. Code § 38006. The difference in the taxing jurisdiction of a State flowing from the character of the income being received, of course, necessitates matching interest expense to each class of income.

California's interest expense matching rule addresses this issue. It is hard to fathom how the Constitution would preclude the California rule based upon its intended purpose. We think Hunt-Wesson's characterization of the California interest expense matching rule as an effort to evade constitutional restrictions by circuitous means, Pet.

Brief 21, or a transparent attempt to tax exempt income, Pet. Brief 22, is unjustifiably inflammatory.

We understand the California matching rule to operate in three phases in the context of interest expenses and the receipt of nonbusiness dividend income. First, the multijurisdictional company is permitted, consistent with the fungibility of debt capital, to deduct the entirety of its interest expense to the extent of its business or apportionable interest income. Thus, the California rule allows a multijurisdictional company in practical terms to secure an interest deduction without any regard to how the company used the borrowing in its own mind. Second, again consistent with fungibility, the multijurisdictional company then offsets the remaining interest expense deduction to the extent of the nonbusiness interest and dividend income. Finally, whatever interest expense deduction remains is then allowed against any other apportionable income. The statute applies regardless of whether the multijurisdictional company is a domiciliary or non-domiciliary of California.

The above description does not note the additional adjustment that pertains to dividends declared by companies from previously taxed California income. This adjustment was not applied in here, although the availability of the adjustment does form an alternative basis of Hunt-Wesson's Commerce Clause complaint. Pet. Brief 38ff. This special circumstance may be analyzed separately. We leave to others whether the circumstance has been properly raised before the Court or affords any basis for the claim of discrimination.

C. An Analysis Of The Record Reveals Hunt-Wesson's Argument Of Unconstitutionality Is Based Upon An Erroneous Premise.

Of course, the foregoing description of the operation of the California interest expense matching rule differs from Hunt-Wesson's representations. The differences and the alleged constitutional infirmity that arises therefrom are

1. Hunt-Wesson believes that a multijurisdictional company must first eliminate all non-business interest expense (interest expense related to the production of nonunitary or nonbusiness dividend income) before calculating any reduction (or offset) in the interest expense deduction. Hunt-Wesson contends only business interest expense (interest expense related to unitary or business dividend income) is subject to the reduction.
2. From the understanding described in the preceding paragraph, Hunt-Wesson submits that California on a dollar for dollar basis arbitrarily denies non-domiciliaries a deduction for business interest expense. Extra-territorial taxation results. Hunt-Wesson asserts domiciliaries do not face this same reduction in their business interest expense deduction. Unconstitutional discrimination also results.
3. To supplement the argument of the preceding paragraph, Hunt-Wesson also states that California never tries to tie any part of what Hunt-Wesson calls the "net business interest expense" to either apportionable dividends or nonbusiness dividends. (The phrase is "net" business interest expense," because Hunt-

Wesson acknowledges a non-domiciliary may deduct business interest against business interest income. Pet. Brief 8-9.

Hunt-Wesson's argument is totally premised on a restrictive and unrealistic view of the record in this case.

1. The California Matching Rule Does Not First Exclude All Nonbusiness Interest Expense Of A Non-Domiciliary Before Calculating The Interest Expense Deduction.

The parties' disagreement over the operation of the matching rule is reminiscent of an earlier case where the parties disagreed over an issue central to the proper resolution of the case. *Franchise Tax Bd. v. Alcan Aluminium Ltd.*, 493 U.S. 331, 339-41 (1990) (ruling on applicability of Tax Injunction Act will not be based upon speculation). The settled jurisprudence of the Court permits proper disposition of this case. When it comes to the important matter of determining the federal constitutional limits of state taxation, an essential aspect of state sovereignty, *Dows v. City of Chicago*, 11 Wall. 108, 110 (1871), this Court will examine the entire record to reach its own independent judgment on whether constitutional rights are invaded. *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 176 (1983), quoting *Norton Co. v. Dept. of Revenue*, 340 U.S. 534, 538 (1951).

As to whether California's matching rule first excludes nonbusiness expenses, (Pet. Brief 8-9; Resp. Brief 24-25), we accept the Franchise Tax Board's representations as made in good faith. We know of no reported authority suggesting otherwise, except for the since revised state tax form, Schedule R-5 of Form 100, that was plainly inconsistent with

the governing statute, Cal. Rev. & Tax Code §24344(b). The audit is also consistent with the Board's representations. Ex. 3 to Stip. 12 (C.T. 93) (audit workpaper lacks any such exclusion).

Further, even if Hunt-Wesson's view of the first step is accepted, the first step did not result in any allocation to the claimed category of "nonbusiness interest expense." Pet. Brief 10 (all of the total interest expense was business interest expense). And in the context of the entire record of this case, the lack of any "Step 1" allocation of the disputed interest deduction to nonbusiness interest expense does not reflect a *valid* determination that the entirety of Hunt-Wesson's disputed interest expense was in fact a business interest expense.

Hunt-Wesson undoubtedly took its return position that all of its interest expense was business interest expense to support its legal position that all of its expense should be deductible. But it appears Hunt-Wesson's return position was developed from an erroneous legal standard. Pet. Brief 5 ("[a]ccordingly" Hunt-Wesson's deduction taken because none of the debt capital went to any of the nonunitary affiliates). The crucial point is that the absence of showing direct investment of the debt capital in the operations of the nonunitary affiliates does not negate the possible use of this capital to produce the constitutionally exempt dividend income. The debt capital may have freed other capital for use in the operations of the nonunitary ventures or have been used to finance the carrying of the ownership interest itself in these ventures. See pp. 17-18, below.

Additionally, Hunt-Wesson's endorsement of other "reasonable" or "fair" methods of allocation, like the asset (cost or value) or gross income ratio

methods, clearly acknowledges some portion of the disputed interest expense is properly attributed to the nonbusiness dividend income. Pet. Brief 25-26 (other fair methods exist; reasonable allocation of interest expenses would obviate the constitutional issues raised by this case); 28 (different allocations methods adopted by other States are fair); 30ff. (Federal Government's methods similarly fair).

Hunt-Wesson's assertion that it first had to exclude all nonbusiness interest expense had no impact on the calculation of the limitation of the interest expense deduction as a matter of fact or of constitutional interpretation. The parties' disagreement reflects nothing more than Hunt-Wesson's seizing upon a since corrected administrative misstep.

Further, we do not view the stipulation 11 (J.A. 20), heavily relied upon by Hunt-Wesson, in the same light. Hunt-Wesson argues stipulation 11 means only the business interest expense portion of a non-domiciliary's interest expense deduction is potentially subject to being offset against constitutionally exempt income. Pet. Brief 8-9, 24-25.

Based upon its belief that all nonbusiness interest expenses are first eliminated from the offset calculus, Hunt-Wesson describes the portion of a non-domiciliary's interest expense deduction that is actually set off against constitutionally exempt income as "Net Business Interest Expense." Pet. Brief 9. Hunt-Wesson persistently uses this phrase or concept to color the California rule. *E.g.*, Pet. Brief 10 ("all of which was business interest expense"); Pet. Brief 23 ("net business interest expense must be reduced"); Pet. Brief 24 n.18 ("it is 'net' business interest . . . that remains"); Pet. Brief 24 n.19 (statute limits net business interest expense); Pet. Brief 24 ("just an arbitrary assignment,

on a dollar-for-dollar basis, of business interest expense"); Pet. Brief 25 (nonbusiness interest expense eliminated prior to calculating the offset).

However, Hunt-Wesson's interpretation of stipulation 11 misses the mark. Apart from the characterization not reflecting the governing statute, Cal. Rev. & Tax Code §24344(b), the stipulation fairly interpreted in light of the other stipulations describes nothing more than the return position of taxpayer, specifically its completion of Schedule R-5. This limited understanding of the stipulation is supported by the next immediate stipulation, no. 12 (J.A. 20) and Ex. 3 to no. 12 (C.T. 93), that describes the audit adjustment of the taxpayer's return that is the subject of stipulation 11. Tellingly, the audit report calculates the interest offset, Ex. 3, without any step for eliminating nonbusiness interest expense. Therefore, if the Court accepts the Franchise Tax Board's characterization of Schedule R-5 (Resp. Brief 24-25), stipulation 11 describes nothing more than the Hunt-Wesson's tax reporting position on an erroneous form. California then corrected Hunt-Wesson without regard to any of the instructions on Schedule R-5.

Regardless of these observations, the Court has little to rely upon to issue a constitutional pronouncement on an allegedly "important federal question" in the face of California's representation to the Court that it does not administer Cal. Rev. & Tax Code §24344(b) in the manner alleged by Hunt-Wesson. Resp. Brief 24-25. This matter clearly is not a case where the State is engaging in sleight of hand to avoid a constitutional determination. Hunt-Wesson outlines no prejudice from California's correction. If Hunt-Wesson's case collapses from California's remedial action, that is the way it

should be. California's express statement of how it administers the statute alleged to offend the Constitution is constitutional protection enough. Nothing would be gained from a declaration by the Court that would hold this kind of rule to be constitutionally invalid, if that were the kind of ruling the Court would otherwise make. See *Diffenderfer v. Central Baptist Church of Miami, Florida*, 404 U.S. 412 (1972) (*per curiam*).

2. The Record Fails To Support The Assertion That The Borrowings Giving Rise To The Disputed Interest Expense Deduction Lack Any Relationship With The Nonbusiness Dividend Income.

Surprisingly, Hunt-Wesson relies heavily upon stipulation 9 as establishing that none of its borrowings can be tied to the nonbusiness dividend income. Stipulation 9 (J.A. 19) states:

For the fiscal years at issue, [Hunt-Wesson] did not make direct operating loans to its foreign subsidiaries. Each foreign subsidiary was directly responsible for its own borrowings.

Using stipulation 9, Hunt-Wesson asserts that all of its interest expense is necessarily deductible. Pet. Brief 5 (because of the facts of stipulation 9 an interest expense deduction was "[a]ccordingly" claimed). This was also the view of the Superior Court that ruled in favor of Hunt-Wesson. Pet. Brief 13 (quoting the Superior Court, facts of stipulation 9 make it appear that none of interest expense can be attributed to the exempt income). With this predicate, Hunt-Wesson concludes that the facts do not support finding any relationship between the borrowings generating the interest expense de-

duction and the nonbusiness dividend income. Pet. Brief 16 (facts do not reveal); Pet. Brief 20 (citing the Superior Court's interpretation of stipulation 9 as authority, Pet. Brief 20 n.14, interest expense did not bear any direct relationship to the nonbusiness dividend income).

Consistent with its view of stipulation 9, Hunt-Wesson also introduces its appeal with the generalized conclusion that the denial of the interest expense deduction occurs even when the deduction bears no relationship to the nonbusiness dividend income. Pet. Brief 2.

But Hunt-Wesson errs in its expansive interpretation of stipulation 9. Stipulation 9 only refers to making direct operating loans to its nonunitary affiliates. It does not negate the borrowings generating the interest expense deduction might have been used to acquire or carry assets that produced the nonbusiness dividend income. Surely, Hunt-Wesson does not dispute that the interest expense of borrowings used to acquire or carry assets that are producing the exempt income is also properly matched against that exempt income. Cf. Section 265, Internal Revenue Code of 1986.

Further, stipulation 9 does not address the issue of whether Hunt-Wesson had a choice to determine which business operation would raise debt capital and which operation would employ already available capital. As the interest arbitrage illustration demonstrates, p. 8, above, if Hunt-Wesson wanted to minimize its California tax exposure, it would have been well-advised to have the unitary business operations do the borrowing and then argue for the unconstitutionality of the California matching rule.

Stipulation 9 does not establish that the total interest expense at issue either was tied to the

production of business or apportionable income or lacked any relationship with the nonbusiness dividend income. Stipulation 9 only states that the pertinent borrowings were not directly used in the production of the income *within the corporate solution* of the nonunitary affiliates. The record does not negate finding some of the interest expense as attributable to the production of nonbusiness dividend income. Hunt-Wesson has endorsed as fair or reasonable other methods of matching interest expense that would undoubtedly attribute interest to its nonbusiness dividends and thereby admits as much. Pet. Brief 28-33.

3. The Matching Rule's Reduction Of A Non-Domiciliary's Interest Expense Deduction Does Not Tax Indirectly Nonbusiness Dividend Income.

Hunt-Wesson also relies heavily on stipulation 14 (J.A. 21) to claim that its net business interest expense deduction was disallowed solely because it received nonbusiness dividends. Stipulation 14 in pertinent part states:

The disallowance of [Hunt-Wesson's] interest expense was due entirely to the receipt by [Hunt-Wesson] of dividends from its nonunitary subsidiaries

Hunt-Wesson joins stipulation 14 with stipulation 9 (J.A. 19) to emphasize its view that disallowance of the interest expense deduction is totally attributable to the offset against the nonbusiness dividend income and that this gives rise to indirect taxation of constitutionally exempt income. Pet. Brief 11 (deduction denied because taxpayer received constitutionally exempt income; Board

made no determination that interest was related to constitutionally exempt income); Pet. Brief 16 (denying interest expense deduction without establishing relationship with exempt income results in taxation of that income); Pet. Brief 19 (only reason for disallowance is receipt of constitutionally exempt income because relationship of the interest expense to that income is irrelevant); Pet. Brief 20 (increase in taxable income attributable entirely to exempt income); Pet. Brief 20 n.15 (to same effect).

But Hunt-Wesson is confusing stipulation 14, a description of the mechanics of the matching rule in this particular and unique case, with the constitutional interpretation of the effects of the rule. Thus, under the California rule there is only a *potential* interest expense reduction against nonbusiness dividend income, if the non-domiciliary actually has such income. The only way for the non-domiciliary receiving nonbusiness dividends to lose some of the interest expense deduction is for the taxpayer to have (fungible) debt capital and nonbusiness dividend income. In this sense, we suppose one could describe the operation of the matching rule as dependent upon the receipt of constitutionally exempt dividend income. But we are puzzled as to what that establishes in a constitutional sense.

It is quite possible under the California matching rule that a non-domiciliary with fungible debt capital and nonbusiness dividend income may never experience any reduction of its interest expense deduction. This could occur when the non-domiciliary has enough business or apportionable interest income to swallow up the interest expense deduction without ever getting to the potential reduction against the nonbusiness dividend income. California

does allow a total deduction of a taxpayer's interest expense against business or apportionable interest income without regard to how the borrowing may have been used. Cal. Rev. & Tax Code §24344(b). Hunt-Wesson apparently did not have enough business or apportionable interest income to take full advantage of California's generous rule. Further, a non-domiciliary with fungible debt capital and nonbusiness assets may have no nonbusiness dividend income at all. Here again, the rule results in no reduction of the interest expense deduction.

In the end, we submit the peculiar and unique circumstances of Hunt-Wesson cannot form a proper description of the California rule as one that always states any interest expense deduction of a non-domiciliary will be reduced dollar for dollar by the nonbusiness dividend income. Hunt-Wesson has not established "indirect taxation" of constitutionally exempt income.

II. HUNT-WESSON HAS NOT ESTABLISHED THAT CALIFORNIA'S MATCHING RULE FOR INTEREST EXPENSE RESULTS IN UNCONSTITUTIONAL STATE TAXATION OF EXTRA-TERRITORIAL INCOME.

We read Hunt-Wesson's first argument, Pet. Brief 18-33, as contending that California is unconstitutionally taxing extra-territorial income. Although the argument is stated in terms of taxing income California is forbidden to tax under the Constitution, e.g., Pet. Brief 16, it is still is an allegation of extra-territorial taxation. See *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980); *Allied-Signal, Inc. v. Director, Div. Of Taxation*, 504 U.S. 768 (1992). But this argument lacks its premise, ignores well-established constitutional doctrine on taxpayer

burden of proof, and amounts to no more than an expressed preference for other tax administrative methods to manage the fungibility of debt capital that this particular taxpayer views as fairer and more reasonable.

A. The Premise Of Hunt-Wesson's Argument Does Not Exist.

In order to carry its argument, Hunt-Wesson represents that California reduces the interest expense deduction only because it received tax exempt dividends without any effort to determine whether the interest expense related to the production of that income. Yet as noted previously with regard to stipulations 9, 11 and 14 (J.A. 19, 20, 21), Hunt-Wesson has bootstrapped an argument that simply does not reflect either the entire record or the actual operation of the California matching rule. See pp. 12-20, above. And Hunt-Wesson gives scant attention to the favorable step of the California matching rule that is based upon the fungibility of debt capital, that is, the allowance of the interest expense deduction on a dollar-for-dollar basis to the full extent of business interest income. Recognition of the reality of fungibility applies both ways for Hunt-Wesson.

B. Hunt-Wesson Has Not Satisfied Its Burden Of Establishing The Existence Of State Taxation Of Extra-Territorial Income.

The California matching rule does not require a reduction of interest expense without regard to the relationship of the deduction to either business dividend income or to nonbusiness or exempt dividend income. See pp. 16-18. Further, we do not agree with Hunt-Wesson that the law ensures that the denial of the deduction will only concern interest

expense that is in fact tied to business dividend income. See pp. 12-16, above. Rather, the California matching rule should be viewed as one of the several different methods that tax administrators use to reflect the undeniable reality that debt capital is fungible. We do not understand Hunt-Wesson to take any issue with the fungibility of debt capital. Pet. Brief 25-26. Given this reality, it is fitting to describe the entirety of the California matching rule as solely concerned with matching the interest expense deduction with the benefiting dividend income.

There is after all no reasonable way to isolate out how a borrowing is being used in fact. Even if the proceeds of a borrowing are traced to being used in a particular fashion, that tracing does not rule out that the borrowing actually permitted the taxpayer to carry some other asset or group of assets rather than to sell them. Similarly, pledging an asset or group of assets does not disclose what part of the business is actually benefiting from the borrowing, since management may have determined that the pledged assets represent the least burdensome collateral without regard to how the debt capital actually was to be used.

But we do not think that these observations would preclude any taxpayer from proving in a rare case that its borrowing and its related interest expense could in fact, due to peculiar factors, be attributed to one type of dividend income. We would not suppose any taxpayer believing that the facts of its circumstance resulted in an unconstitutional assessment of a tax would not be afforded the opportunity to prove those facts.

But Hunt-Wesson does not contend that it was denied any opportunity to prove its borrowings were related to business income. Instead, Hunt-Wesson

resorts to praising the virtues of other methods of interest matching that also operate on the premise of fungibility. Hunt-Wesson's apparent failure to take on the issue of proof of a relationship of the borrowings to apportionable income may well therefore reflect Hunt-Wesson's own realistic acknowledgement that it could not prove this tie. Yet, retreating into silence in the face of the impossibility of proof in a constitutional dispute involving the sensitive issue of the division of income of a multijurisdictional business does not carry the day.

It is a well established principle of constitutional interpretation of the limits of state taxing jurisdiction that the taxpayer bears the burden of establishing the existence of extra-territorial income. *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 164 (1983) (taxpayer has the burden of showing by "clear and convincing evidence" that state is taxing extraterritorial values); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 271-275 (1978) (taxpayer failed in its proof). The rule is further buttressed by the time-honored observation that it is the taxpayer that must show an arbitrary or unreasonable result. *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120-21 (1920). Hunt-Wesson, other than retreating into an argumentative position on the meaning of stipulations and the operation of the California matching rule presents no basis in law or the record, to meet its burden.

C. Hunt-Wesson Expresses No More Than A
Personal Preference For Other Methods Of
Matching An Interest Expense Deduction To
Dividend Income.

Putting aside our disagreement with Hunt-Wesson on the existence of unconstitutional extra-territorial taxation, we find the expressed preference for other methods of interest expense matching, Pet. Brief 26-32, both instructive and frustrating.

Enlightenment comes from the necessary corollary to this endorsement. Hunt-Wesson must believe some portion of its interest expense deduction is appropriately tied to its nonbusiness dividend income. This follows because these other fair and reasonable methods will presumably result in some of Hunt-Wesson's interest expense deduction being attributed to Hunt-Wesson's nonbusiness dividends.

In the end the dispute is over California's method that Hunt-Wesson describes without proof as arbitrary. Pet. Brief 24. In describing this arbitrariness, Hunt-Wesson totally ignores that aspect of the California interest expense matching rule that first allows the taxpayer a total deduction of the interest expense to the extent of business interest income. Hunt-Wesson while acknowledging this portion of the rule in its initial description, Pet. Brief 8-9, never discusses how this provision impacts the fairness of the California rule. The avoidance of this aspect of the California matching rule suggests Hunt-Wesson might face some disagreement over the fairness of the California rule with a non-domiciliary company that has sufficient business interest income to absorb the totality its interest expense deduction.

And the alleged fairness of the methods endorsed by Hunt-Wesson is not readily apparent. Consider interest expense matching by property ratios that Hunt-Wesson describes. Under the asset ratio approach, it is possible a non-domiciliary might face a reduction of its interest expense deduction in situations where the California matching rule would not significantly reduce the expense because the taxpayer had no substantial nonbusiness dividend income.

Some may argue against the fairness of an asset ratio on the basis that the underlying borrowing was secured due to the borrower's ability to generate cash flow and income and not asset value. Also, fairness, including its cousin administrability, comes into play when one realizes a choice must be made between current values and historic costs under the asset ratio approach. And which is fairer, a determination of value of the nonunitary affiliate by outside (e.g., stock) fair market value or acquisition cost or by inside (i.e., assets held in corporate solution) fair market value or acquisition costs?

Similar issues exist with respect to using income ratios. But the point here is not which method of interest expense matching is the best. The diversity of approaches used in matching interest expense itself, documented by Hunt-Wesson, Pet. Brief 28-33, suggests that determining fairness in any absolute sense would be futile. Rather these preliminary observations demonstrate, as the Court recognized in *Moorman*, 437 U.S. at 277-280, that in the absence of the taxpayer's actual proof of unfairness, including the presence of systematic multiple taxation, it would be inappropriate to establish through extensive judicial lawmaking a constitutional standard for income division. This

kind of matter, matching interest expense, is better left to the Congress and/or state legislatures.

III. CALIFORNIA'S INTEREST EXPENSE, MATCHING RULE DOES NOT VIOLATE THE COMMERCE CLAUSE.

A. Hunt-Wesson's Underlying Rationale For Finding Discrimination Is Not Supported By The Record.

Hunt-Wesson acknowledges California's interest expense matching rule would not be discriminatory, if the rule reflected nothing more than the constitutional limitation on California's taxing power over non-domiciliary companies. Pet. Brief 34. There is nothing surprising in this concession. Inevitably, one must conclude a determination of discrimination is not supported by showing a domiciliary company will always have more interest expense available to it in the domiciliary State than a non-domiciliary. Greater deductibility in the domiciliary State follows, because the domiciliary is subject to tax on its nonbusiness dividend income and this income will attract some portion of the deduction of interest expenses.

But Hunt-Wesson states this reality is not applicable here, because the disallowed interest expenses cannot be viewed as relating to the constitutionally exempt dividend income. Pet. Brief 35. Therefore, in Hunt-Wesson's view the disallowance is necessarily based upon the domicile of the taxpayer and not the character of the income received.

Hunt-Wesson's Commerce Clause argument is quite similar to its claim that the California matching rule results in taxation of extra-territorial income. As a part of this claim, Hunt-Wesson asserted in essence that without proof of the relationship of

the disallowed interest expense to nonbusiness dividend income, California must be treated as taxing extra-territorial income. We will not repeat our analysis of the claim of extra-territorial taxation that demonstrated Hunt-Wesson lacks the support of the record and disregards applicable constitutional principle. See p. 21 that references pp. 12-20.

We note, however, that while Hunt-Wesson rejects the California matching rule as a reasonable convention for establishing the relationship between the disallowed interest and nonbusiness dividend income, it endorses other "fair" and "reasonable" methods that utilize fungibility of debt capital to make an apparently valid determination of the necessary relationship. But Hunt-Wesson's endorsement is not based upon any empirical proof that the elements used in its "approved" methods are any better suited to be the surrogates for attributing interest expense to the appropriate class of income than the elements of interest and dividend income used in the California rule. This expected gap in proof reflects that any of the conventions could be attacked in some of the possible circumstances that give rise to the need to accomplish the matching. *E.g.*, pp. 24-25, above. The existence of so many variants itself suggests the self-evident observation that in reality there is no single correct answer to choosing the perfect approximation for matching interest expense to the classes of dividend income.

B. In Any Event, Hunt-Wesson Has Not Proved The California Interest Matching Rule Favors Domiciliaries Over Non-Domiciliaries.

Hunt-Wesson's viewpoint taken at face value does not support a determination of Commerce Clause discrimination. There can be no determi-

nation of discrimination, because no calculus demonstrates that non-domiciliaries generally face a higher tax burden under the California interest expense matching rule.

Certainly, facial discrimination is not present, because domiciliaries and non-domiciliaries face the exact same rule. It is the character of the income received that determines the availability of an interest expense deduction. There is nothing in the rule itself that discloses tax differentiation based upon domicile.

For another, discrimination in operation cannot be established by claiming non-domiciliaries generally are worse off under the rule. As previously noted all of the matching rules have their good and bad points as clearly demonstrated by circumstances where the California rule might be better for non-domiciliaries than the other "rational" rules Hunt-Wesson views as reasonable. *E.g.*, pp. 19-20, 24-25. What Hunt-Wesson has done is to assert unconstitutionality based upon its own unique factual circumstances and then to claim the other methods that are more generous to it than the California matching rule are constitutional. Yet the Commerce Clause protects the integrity of the interstate and international markets, not particular firms. See *Exxon Corp. v. Governor of Maryland*, 437 U.S. 117, 127-28 (1978).

Finally, the calculus of discrimination cannot be completed in any event, because the availability of a deduction dependent upon domicile is not the only aspect of the California franchise tax system that must be examined to determine tax cost. What Hunt-Wesson describes as the more favored position of a domiciliary company carries the uncertain cost of total taxability of nonbusiness dividend income

based upon the presence of the taxpayer's commercial domicile. This added cost occurs within a single integrated tax, the California franchise tax based upon net income, and arises out of the need to match expenses with two classes of dividend income. In these circumstances we do not understand that the restrictions against using the compensatory tax doctrine would apply at all. Cf. *Washington v. United States*, 460 U.S. 536, 542-43 (1983) (discrimination established by an examination of the whole tax structure of the State); *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).

No one can claim in this situation that there would be any incentive for a non-domiciliary taxpayer to be treated like a domiciliary so that it could use a greater proportion of its interest expense deduction. After all, the total tax could vary considerably each year depending upon the taxpayer's specific, but uncertain, tax attributes. Thus, the total amounts of interest expense, business or apportionable income, apportionable interest and dividend income, and nonbusiness dividend income will be uncertain as to the future, to say nothing of other attributes.

But inability to calculate any discrimination cost as described above would not allow a State to deny any interest expense deduction related to business or apportionable income to non-domiciliaries, while granting it to domiciliaries. In this latter case, which Hunt-Wesson attempts to paint as its circumstance by contending that the California rule requires the total exclusion of nonbusiness interest expense from the calculation of the offset, *e.g.*, Pet. Brief 8-9, the taxing State offers no possibility of any benefit from deducting interest expenses related to business or apportionable income to a non-domiciliary while

affording that opportunity to the domiciliary. That kind of treatment would be discriminatory. But here the California rule preserves a realistic opportunity under various circumstances that the non-domiciliary will secure benefit from its interest expense, and in some cases on a very favorable basis. *E.g.*, taxpayer's business interest income is sufficient to cover the total interest expense, even though taxpayer holds nonbusiness assets paying nonbusiness dividend income.

CONCLUSION

In its simplest terms, the taxpayer seeks this Court's mandate to establish a constitutional rule for how States should match deductible interest expense to taxable and nontaxable income. Adoption of this rule would depart from settled principles governing the sensitive issue of state taxation in our federal system and would place the Court into the quagmire of extensive judicial law making. The Court should affirm the decision below with a mandate that Hunt-Wesson's claim be dismissed.

RESPECTFULLY SUBMITTED,

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IN THE
Supreme Court of the United States

HUNT-WESSON, INC.,

v.

Petitioner,

FRANCHISE TAX BOARD,

Respondent.

On Writ of Certiorari to the
Court of Appeal of California
for the First Appellate District

BRIEF OF GENERAL ELECTRIC COMPANY
AS *AMICUS CURIAE*
IN SUPPORT OF PETITIONER

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QUESTIONS PRESENTED

1. Whether a State may tax constitutionally exempt income under the guise of denying a deduction for expenses in an amount equal to such income when there is no evidence that the expenses relate to the production of the exempt income.

2. Whether a state tax discriminates against interstate commerce in violation of the Commerce Clause by disallowing an otherwise deductible expense, thereby increasing California taxable income, solely because the corporation is not domiciled in the State or does not have subsidiaries that engage in taxable in-state activity.

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IN THE
Supreme Court of the United States

No. 98-2043

HUNT-WESSON, INC.,
v. *Petitioner,*
FRANCHISE TAX BOARD,
Respondent.

On Writ of Certiorari to the
Court of Appeal of California
for the First Appellate District

BRIEF OF GENERAL ELECTRIC COMPANY
AS *AMICUS CURIAE*
IN SUPPORT OF PETITIONER

INTEREST OF *AMICUS CURIAE*¹

The General Electric Company ("GE") is a multistate and multinational company headquartered in Fairfield, Connecticut. GE operates in more than 100 countries around the world and employs over 290,000 people. Over half of those employees are in the United States, and over 10,000 in the state of California alone. GE has numerous business segments that provide a broad range of goods

¹ Pursuant to Rule 37.6 of the Rules of this Court, *amicus* states that no counsel for a party authored this brief in whole or in part, and that no person or entity other than *amicus*, its members, or its counsel, has made any monetary contribution to the preparation or submission of this brief. Pursuant to Rule 37.3, *amicus* states that petitioner and respondent have consented to the filing of this brief. Their letters of consent have been filed with the Clerk of this Court.

and services throughout the United States and the world, including aircraft engines, appliances, capital services, industrial systems, lighting, medical systems, the NBC television network, plastics, power systems and transportation systems. In 1998, GE revenues exceeded \$100 billion, with net earnings of over \$9 billion. As a result, GE bears substantial tax burdens, both in the United States and abroad.

GE believes it is evident that California's dollar-for-dollar interest offset rule has a significant, deleterious effect on interstate commerce, which will only be exacerbated if other states follow California's lead and adopt similar offset provisions. GE believes that all of the states will best be served by tax rules that properly recognize the interstate character of many companies' businesses through a proper allocation of expense to taxable and nontaxable classes of income. Because of its years of practical experience with state taxation, GE believes that it is uniquely suited to assist the Court in evaluating the dollar-for-dollar interest offset rule California improperly has adopted, and to that end offers its insights into the legal issues raised by this case.

SUMMARY OF ARGUMENT

California is proscribed under the Due Process and Commerce clauses from taxing income of a nondomiciliary corporation that is not connected to the trade or business it carries on in California. Consequently, as a general matter, California is precluded from taxing dividends that a nondomiciliary corporation receives from a subsidiary, if the subsidiary and the nondomiciliary parent are not engaged in an integrated trade or business. The statute at issue in this case, Cal. Rev. & Tax. Code § 24344(b), however, applies an "interest offset" rule that arbitrarily requires a nondomiciliary corporation to reduce its deduction for net interest expense (*i.e.*, business interest expense

in excess of business interest income), dollar-for-dollar, by the amount of income it receives that California may not constitutionally tax.

This Court has never permitted constitutionally tax exempt income to be used to offset other expenses, unless the government demonstrates that the expenses are attributable to the nontaxable income either by means of a direct tracing or by proration or apportionment of expense between taxable and nontaxable income. *E.g.*, *National Life Ins. Co. v. United States*, 277 U.S. 508, 520-22 (1928); *United States v. Atlas Life Ins. Co.*, 381 U.S. 233, 249-51 (1965).

California's interest offset rule is fundamentally flawed under this approach because it uses constitutionally nontaxable income to offset unrelated expenses, dollar-for-dollar, instead of making any attempt to match the interest expense to the taxable and constitutionally nontaxable income to which it is related. As a result, the interest offset rule is unconstitutional for two reasons. *First*, it permits California to tax indirectly that which it cannot tax directly. *Second*, by disallowing a deduction solely because the taxpayer is a nondomiciliary corporation, the interest offset rule facially discriminates against interstate commerce and *per se* violates the Commerce Clause.

ARGUMENT

I. BACKGROUND.

A. Constitutional Limitations On State Taxation.

California imposes a franchise tax, measured by net income, on all corporations doing business in the state. Cal. Rev. & Tax. Code §§ 23151, *et seq.* Like all states, California is prohibited by the Commerce and Due Process clauses of the United States Constitution from taxing

income of a nondomiciliary corporation if that income is earned outside California and bears no connection to a trade or business the corporation conducts in California. U.S. Const. art. I, § 8, cl. 3, and amend. XIV, § 1; *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 777 (1992). This type of income is commonly referred to as "nonbusiness" income.² The parties to this case have stipulated that the dividends that are at the center of this controversy were nonunitary, nonbusiness dividends not subject to taxation by the State of California. Joint Stipulation of Facts ¶ 8, Clerk's Transcript p. 58. The dividends were not subject to California tax because California was constitutionally prohibited from taxing such dividends.

In order for a state to tax a nondomiciliary corporation's income derived from out-of-state activities, there must be both a nexus between such activities and the taxing state and a rational relationship between the income attributed to the taxing state and the extent of business conducted in the state. *E.g.*, *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 165-66 (1983). In other words, a state may tax income from a taxpayer's out-of-state activities only if those activities are part of the integrated activities of a "unitary business."³

² The term "nonbusiness" income is a statutory term that generally includes income that a state cannot tax because it does not bear the operational connection to the business conducted in the taxing state that is required by *Allied-Signal*. For ease of reference, we will refer to such income generically, and interchangeably, as "nonbusiness," "nontaxable" or "exempt" income.

³ A unitary business exists when the intrastate and out-of-state activities of a company are integral parts of a single enterprise. A unitary business may include vertically integrated entities of one enterprise or several similar entities operating in various jurisdictions but conducting a common enterprise. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 166 (1983). The hallmarks of a unitary

A state may tax income a nondomiciliary corporation receives from intangible assets, such as dividend income, only if the payor of the income is engaged in a unitary business with the payee or if the income-generating asset serves an operational, rather than an investment, function of the payee. *Allied-Signal*, 504 U.S. at 777. For example, in *Mobil Oil Corp. v. Commissioner of Taxes*, the Court held that Vermont was permitted to tax dividends that Mobil, a nondomiciliary, received from foreign subsidiaries because the subsidiaries' petroleum production operations were part of a unitary business with Mobil's petroleum retailing operations in Vermont. 445 U.S. 425, 439 (1980). In contrast, the Court held that a state could not tax the dividends a nondomiciliary corporation received from nonunitary subsidiaries in *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 327-28 (1982), and *F.W. Woolworth Co. v. Taxation & Revenue Department*, 458 U.S. 354, 364 (1982). Most recently, the Court in *Allied-Signal* held that New Jersey could not tax the gain that Allied-Signal's predecessor in interest, Bendix Corp., a nondomiciliary, realized on the sale of its 20.6% stock interest in ASARCO. 504 U.S. at 787. Bendix and ASARCO were not engaged in a unitary business and Bendix's interest in ASARCO served an investment rather than an operational function, even though the ASARCO stock had been purchased as part of a long-term strategy of corporate acquisitions and dispositions. *Id.*

These principles establish that California could not, consistent with the Constitution, directly tax the dividends at issue, which the parties stipulated were nonunitary, nonbusiness dividends.

business are operations linked by functional integration, centralization of management, and economies of scale. *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 438 (1980); *F.W. Woolworth Co. v. Taxation of Revenue Dep't*, 458 U.S. 354, 364 (1982).

B. California's Taxation Of Business And Nonbusiness Income.

In order to implement the constitutional limitations on state taxation, states use a number of specific allocation rules for attributing nonbusiness income to the state in which it is earned. Generally, income derived from tangible property (whether personal or real) is allocated to the state in which the property is located. California has adopted such a rule. Cal. Rev. & Tax. Code § 25124. In contrast, income from intangible property, such as interest and dividend income (the type of income involved in this case), generally is allocated entirely to the commercial domicile of the recipient of the dividends. That rule, too, has been adopted by California. *Id.* § 25126.

Most, if not all, states that impose an income tax, including California, require a corporation to apportion by formula income earned from a trade or business ("business income") conducted both within and without the taxing state. Although there are some variations among the states, the apportionment formulae generally take into account the proportions of the corporation's property, payroll and sales in the taxing state in determining the share of the corporation's business income that the state may subject to tax.⁴ In determining the amount of net taxable business income that may be apportioned, most states, again including California, permit a deduction from gross income for interest expense paid or incurred. *Id.* § 24344(a).

California, however, intentionally overreaches by arbitrarily limiting a corporation's interest deduction in a

⁴ California used the "three-factor" property, payroll and sales formula during the tax years in issue, but began using a variation on that formula that gives double weight to sales, effective October 8, 1993. Cal. Rev. & Tax. Code § 25128.

manner that violates both the Due Process and Commerce clauses. The specific limitation in question is the so-called "interest offset" rule. *Id.* § 24344(b).⁵ That rule arbitrarily requires a corporation to reduce all of its net interest expense (*i.e.*, the excess of its business interest expense over its business interest income), dollar-for-dollar, by the amount of its nonbusiness dividend and interest income, which *cannot* properly be taxed by California. The interest offset overreaches by failing to match that interest expense to the business and nonbusiness income to which it is related—whether by a direct tracing or by a reasonable apportionment. Instead, it simply assigns the first dollars of net interest expense to income that California may not tax, and allows only the balance, if any, to be used as a deduction from the income that California taxes. See *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 498 P.2d 1030, 1035 (Cal. 1972).

The abject failure of section 24344(b) to match interest expense to the related taxable and nontaxable income has two unconstitutional effects. *First*, in violation of the Due Process and Commerce clauses, it permits California effectively to tax nonbusiness income, which is, by definition, income that California is constitutionally prohibited from taxing. *Second*, in violation of the Commerce

⁵ During the tax years in issue, Section 24344(b) (1979) provided:

If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula.

Clause, it results in facial discrimination against interstate commerce by disallowing a deduction based solely upon the commercial domicile of the taxpayer. Put differently, the interest offset rule favors corporations with a commercial domicile in California while at the same time disadvantaging corporations whose commercial domiciles are elsewhere.

II. THE INTEREST OFFSET RULE IMPROPERLY PERMITS CALIFORNIA TO TAX INDIRECTLY THAT WHICH IT CANNOT TAX DIRECTLY.

It is well settled that a state may not tax indirectly that which it cannot constitutionally tax directly. *E.g.*, *The Passenger Cases*, 48 U.S. (7 How.) 283, 458 (1849) (Grier, J., opinion); *Frick v. Pennsylvania*, 268 U.S. 473, 495 (1925); *Lee v. Osceola & Little River Rd. Improvement Dist. No. 1*, 268 U.S. 643, 645-46 (1925). The effect of section 24344(b) is to permit California to tax indirectly the nonbusiness dividends that it is constitutionally precluded from taxing directly. Specifically, by reducing the interest expense deduction, dollar-for-dollar, by the amount of nontaxable, nonbusiness income, California increases the tax base of a nondomiciliary corporation by the exact amount of its constitutionally nontaxable, nonbusiness income.

A. California Does Not Fairly Attribute Interest Expense To Nontaxable Income.

It is undisputed that California may burden nontaxable income with the expenses attributable to generating that income. The fundamental flaw of section 24344(b) is that it provides no mechanism for matching interest expense to the taxable or nontaxable income to which it is related. Instead, it arbitrarily assigns net interest expense first to constitutionally nontaxable income and allows only

the balance, if any, to be used as a deduction against taxable income.

1. The State May Disallow Only That Interest Which Is Fairly Related To The Nontaxable Income.

This Court has never permitted constitutionally tax exempt income to be used to offset other expenses, unless the government demonstrates that the expenses are attributable to the nontaxable income either by means of a direct tracing or by proration or apportionment of expense between the taxable and nontaxable income. The Court addressed this issue over 70 years ago in *National Life Insurance Co. v. United States*, 277 U.S. 508, 521 (1928), and as discussed below, has not wavered from the principles set forth in that case.

In *National Life*, section 245(a) of the Revenue Act of 1921 reduced an insurance company's federal income tax deduction for additions to its reserve, dollar-for-dollar, by the amount of its tax exempt income (*i.e.*, income from state and municipal obligations that was constitutionally exempt from federal taxation). The taxpayer thus paid the same amount of tax whether its income was comprised of taxable or tax exempt income, prompting the Court to observe: "One may not be subjected to greater burdens upon his taxable property solely because he owns some that is free." *Id.* at 519.

In *Denman v. Slayton*, 282 U.S. 514, 518 (1931), the Court upheld section 214(a)(2) of the Revenue Act of 1921, which denied a federal income tax deduction for interest paid or accrued "on indebtedness incurred or continued to purchase or carry" tax exempt securities. The taxpayer paid the interest on "money borrowed . . . for the purpose of purchasing and carrying exempt securities." *Id.* at 517 (emphasis added). In that case there

was a directly traceable relationship between the interest disallowed and the exempt securities. The Court explained that:

[w]hile guaranteed exemptions must be strictly observed, this obligation is not inconsistent with *reasonable* classification designed to subject all to the payment of their *just* share of a burden *fairly* imposed.

Id. at 519 (emphases added).

In *United States v. Atlas Life Insurance Co.*, 381 U.S. 233, 249-51 (1965), the Court upheld a *pro rata* apportionment of exempt securities between taxable and nontaxable income. Under the Life Insurance Company Income Tax Act of 1959, a life insurance company's investment income was divided between the policyholders' share (*i.e.*, the reserve for payment of future claims) and the company's share (its own taxable investment income). Pooled investments, including tax exempt interest income, were allocated *pro rata* between the policyholders' and the company's share of income. In computing its taxable investment income, the company was entitled to deduct the *pro rata* portion of tax exempt income included in the company's share of investment income. The taxpayer, however, argued that it should have been able to allocate all of the tax exempt investment income to the company's share, because the company did not pay any tax on the policyholders' share in any event. The Court rejected this argument, stating:

[T]he formula treats taxable and exempt income in the same way, deeming that both are saddled with an equal share of the company's obligation to policyholders. We think that Congress can treat the receipts from investment of a pool of fungible assets in this manner and that the taxpayer's desired allocation of these receipts is not constitutionally required.

Id. at 250. The Court specifically distinguished this constitutional allocation from the dollar-for-dollar offset found unconstitutional in *National Life*. *Id.* at 243-44.

More recently, in *First National Bank v. Bartow County Board of Tax Assessors*, 470 U.S. 583, 588-97 (1985), the Court addressed a Georgia property tax imposed on the fair market value of a bank's stock. The Court earlier had ruled in *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 865 (1983), that Rev. Stat. § 3701, as amended, 31 U.S.C. § 742, prohibited a state from imposing a property tax on bank shares without allowing a deduction for federal obligations. The Georgia Supreme Court construed its state's taxing statute to allow a deduction from net worth in the same proportion as the bank's federal obligations to the bank's total assets. In other words, if the bank's federal obligations constituted 9.75% of its total assets, then the bank was entitled to a deduction of an amount equal to 9.75% of its net worth. In upholding this scheme, the Court stated:

We see no need to depart from the principle established in *Atlas Life* that a *pro rata* deduction that does no more than allocate to tax-exempt values their "just share of a burden fairly imposed" is constitutional. 381 U.S., at 251.

First Nat'l Bank, 470 U.S. at 596.

The Court has thus made it abundantly clear that expenses may be attributed to nontaxable income if—and only if—there is a reasonable, but firm relationship between the expenses and the income to which it is to be related. Even where assets and expenses are fungible, this relationship can only be established either by a direct tracing or by a *pro rata* apportionment. The Court clearly has rejected the arbitrary assignment of expenses to constitutionally nontaxable income.

California attempts to defend its arbitrary assignment of interest expense to nontaxable income on the ground that money is fungible and cannot be readily traced. Opp. 12. From that general observation, however, the state jumps to the unwarranted conclusion that the statute reflects "an attempt by the California Legislature to address the complex issue of interest allocation in a rational manner." *Id.* at 13. This argument rings hollow in light of the conclusions reached by this Court in *National Life* and *Atlas Life* that exempt income from fungible investment funds could *not* be subjected to a dollar-for-dollar offset, but rather had to be prorated in some manner to reflect taxable and nontaxable investments.

2. California Itself Prorates Interest Expense Between Taxable And Nontaxable Income In Other Comparable Contexts.

The Franchise Tax Board has taken the administrative position that, in the event that Hunt-Wesson prevails in this litigation, the State will begin prorating interest expense between taxable and nontaxable income. California requires a similar proration in other contexts, as well. It is thus no answer to say that the matching of interest expense to the related classes of income is simply too difficult and that California should be spared the bother.

By letter dated December 23, 1997 (the "FTB Letter," attached as Appendix), the Franchise Tax Board informed *amicus curiae* General Electric that in General Electric's docketed administrative case the Board would prorate General Electric's interest expense between nontaxable nonbusiness income and taxable business income in the event Hunt-Wesson prevails in this Court. FTB Letter at 1. Specifically, the Board stated that it would apply the "asset allocation" method to determine a non-

domiciliary's allowable interest expense. The Board set forth the following rationale for its position:

Authority for the asset allocation method is found in R&TC § 25120 and 18 CCR § 25120(d). 18 CCR § 25120(d) provides for the proration of deductions between business and nonbusiness income where expenses related to both classes of income and the proration method fairly distributes the expense. The basis for an asset allocation method to prorate expenses is that money is *fungible* and is attributable to all activities of the taxpayer.

Id. (emphasis added).⁶

The Franchise Tax Board further explained that the "asset allocation" method generally follows the rules set forth in Cal. Code Regs. tit. 18, § 24344(c).⁷ The asset allocation method propounded by the FTB Letter and by Cal. Code Regs. tit. 18, § 24344(c) generally allocates interest expense directly to assets acquired with the pro-

⁶ Cal. Code Regs. tit. 18, § 25120(d) provides:

Proration of Deductions. In most cases an allowable deduction of a taxpayer will be applicable only to the business income arising from a particular trade or business or to a particular item of nonbusiness income. In some cases an allowable deduction may be applicable to the business incomes of more than one trade or business and/or to several items of nonbusiness income. In such cases the deduction shall be prorated among such trades or businesses and such items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable.

GE expresses no view as to whether Cal. Rev. & Tax. Code § 25120(d) and Cal. Code Regs. tit. 18, § 25120(d) do in fact provide the Franchise Tax Board with statutory authority to impose an asset allocation method, or whether that method allocates the proper amount of expenses to nontaxable income.

⁷ The purpose of Cal. Code Regs. tit. 18, § 24344(c) is to attribute a *pro rata* portion of interest expense to certain dividends from foreign subsidiaries that are deductible from apportionable business income under Cal. Rev. & Tax. Code § 24411.

ceeds of secured, nonrecourse loans, and prorates the remaining interest expense between taxable and nontaxable income on the basis of the relative values of the taxpayer's taxable and nontaxable assets.

California also has applied a similar apportionment of interest expense between taxable and nontaxable income in other comparable contexts. For example, California permits a deduction under section 24410 for certain dividends received during the year from insurance companies. In that case, California requires the dividend recipient to reduce its deductions only by the amount of its expenses (including interest) attributable to such exempt dividends. For this purpose California prorates a taxpayer's expenses between deductible dividend income and total gross income by multiplying the taxpayer's total expenses by the percentage that its nontaxable dividend income bears to its total gross income. See *In re Appeal of Mission Equities Corp.*, 1975 WL 3263 (Cal. St. Bd. Eq. Jan. 7, 1975); *In re Appeal of Sierra Pac. Indus.*, 94-SBE-002, 1994 WL 14076 (Cal. St. Bd. Eq. Jan. 5, 1994); *In re Appeal of Zenith Nat'l Ins. Corp.*, 98-SBE-001-A, 1998 WL 1109371 (Cal. St. Bd. Eq. Jan. 8, 1998).

In sum, California has established a pattern of prorating expenses between taxable and nontaxable income when the income is nontaxable by statute (as is the case, for example, with respect to sections 24410 and 24411). It is only where the state is prohibited from taxing the dividend income by operation of the Constitution that California uses the full amount of that income to reduce, dollar-for-dollar, the taxpayer's deductible interest expense.

B. Because The Interest Offset Rule Does Not Fairly Attribute Net Interest Expense To The Related Income, It Improperly Permits California To Tax Indirectly That Which It Cannot Tax Directly.

The failure of the interest offset rule to match net interest expense to the taxable and nontaxable income to which it is related permits California to tax indirectly the nonbusiness dividends that it is constitutionally precluded from taxing directly. The Court struck down a substantially similar dollar-for-dollar offset in *National Life Insurance Co.*, 277 U.S. at 520-21. As the Court noted, "it becomes apparent that petitioner was accorded no advantage by reason of ownership of tax exempt securities." *Id.* at 519. The Court subsequently summarized its reason for concern in *National Life*:

[T]he result [was] that the company paid as much tax as it would have paid had the same total income been entirely from taxable sources. Under that provision, a company shifting its investments from taxable to nontaxable securities would have lowered neither its taxable income nor its total tax. As compared with the company deriving its income only from taxable sources, the enterprise with the same total amount of investment income derived partly from exempt and partly from taxable sources would pay more tax per dollar of taxable gross income, *i.e.*, taxable income before deduction for the reserve. Unable to perceive any purpose in reducing one deduction by the full amount of another, save for an intent to impose a tax on exempt receipts, the Court ruled that "[o]ne may not be subject to greater burdens upon his taxable property solely because he owns some that is free." 277 U.S., at 519.

Atlas Life Ins. Co., 381 U.S. at 243-44 (third alteration in original).

As a direct result of the interest offset rule, the non-California taxpayer is "accorded no advantage by reason of ownership" of nonbusiness assets outside the state, which are beyond California's ability to tax. Because the statute does not require any relationship between the disallowed interest expense and the nontaxable income, the effect is simply to tax the constitutionally nontaxable income. The following example illustrates this point:

Example 1. Parent ("P") is domiciled in Illinois, does business in California, and has a wholly-owned, nonunitary subsidiary ("Sub A"). P has business income of \$200, business interest expense of \$150 and no business interest income. P does not receive any dividend income from Sub A. P's \$150 of interest expense is deducted in full from P's \$200 of business income because there is no nonbusiness dividend or interest income to offset the interest deduction. Thus, P's income subject to apportionment and taxation by California is \$50.

If Sub A were now to pay a \$100 dividend to P, that dividend would constitute nontaxable, nonbusiness income for P since Sub A is a nonunitary subsidiary. California is constitutionally prohibited from taxing P for this out-of-state income. In this case, however, California requires P to offset the \$100 of nontaxable nonbusiness dividend income against its \$150 of interest expense, leaving only \$50 of interest expense for P to deduct from its \$200 of business income. Thus, P's income subject to apportionment and taxation by California now rises to \$150.

As this example demonstrates, P's apportionable business income increases from \$50 to \$150 solely as a result of the receipt of \$100 of nontaxable dividend income. In other words, the result of the California interest offset is to increase P's apportionable business income by \$100,

exactly the same amount as P's dividend income that California may not constitutionally subject to taxation.⁸ Viewed from another perspective, P's apportionable business income in this instance (\$150) is the same that it would have been if all of its \$300 of gross income had consisted of business income. P is thus afforded no benefit from its ownership of nonbusiness, nontaxable assets. This is exactly what the Court found impermissible in *National Life*.

III. THE INTEREST OFFSET RULE DISCRIMINATES AGAINST INTERSTATE COMMERCE BY DISALLOWING A DEDUCTION TO A NON-DOMICILIARY CORPORATION SOLELY ON THE BASIS OF ITS DOMICILE.

A. Facial Discrimination Against Interstate Commerce Is Virtually *Per Se* Invalid.

It is also well settled that "State laws discriminating against interstate commerce on their face are 'virtually *per se* invalid.'" *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 575 (1997) (quoting *Fulton Corp. v. Faulkner*, 516 U.S. 325, 331 (1996) (quoting *Oregon Waste Sys., Inc. v. Department of Envtl. Quality*, 511 U.S. 93, 99 (1994))). See also *South Cent. Bell Tel. Co. v. Alabama*, 119 S. Ct. 1180, 1185 (1999) (holding invalid an Alabama franchise tax that facially discriminated against interstate commerce). As the Court observed in *Oregon Waste Systems, Inc. v. Department of Environmental Quality*:

Because the Oregon surcharge is discriminatory, the virtually *per se* rule of invalidity provides the proper legal standard here, not the *Pike* balancing

⁸ Of course, if P's dividend income is greater than its interest expense, California will be unable to tax *all* of P's dividend income by operation of the offset rule. However, *any* taxation of that income that is not connected to the state is unconstitutional.

test. As a result, the surcharge must be invalidated unless respondents can "sho[w] that it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives." Our cases require that justifications for discriminatory restrictions on commerce pass the "strictest scrutiny." The state's burden of justification is so heavy that "facial discrimination by itself may be a fatal defect."

511 U.S. 93, 100-01 (1994) (citations omitted and alteration in original).

For the reasons set forth by Hunt-Wesson in its brief, section 24344(b) facially discriminates against interstate commerce in violation of the Commerce Clause by disallowing an otherwise deductible expense to a nondomiciliary corporation, thereby increasing California taxable income based solely on the fact that the taxpayer is domiciled outside California.

B. Section 24344(b) Facially Discriminates Against Interstate Commerce.

California's interest offset rule treats local corporations more favorably than their out-of-state competitors. A local corporation obtains a deduction for all of its interest expense whether or not it has nonbusiness income, whereas a nondomiciliary corporation has its net interest expense deduction reduced by the amount of its nonbusiness income—even if the interest expense bears no relationship to that nontaxable nonbusiness income. Because disallowance of the deductions turns solely on the domicile of the corporation, *i.e.*, whether California taxes the corporation's intangible income as its state of domicile, the offset rule facially discriminates against interstate commerce and is *per se* invalid.

One would normally expect a California-domiciled corporation to have a significantly higher amount of California taxable income than an out-of-state corporation with identical items of business income, nonbusiness dividend income and interest expense. Each corporation would have the same amount of taxable business income apportioned to California. At the same time, the nonbusiness dividends received by the California-domiciled corporation would be allocated exclusively to, and taxed only by, California, while the nonbusiness dividends received by the out-of-state corporation would be constitutionally exempt from taxation in California. The interest offset rule upends this expectation in a manner that discriminates against interstate commerce.

The discrimination inherent in California's interest offset rule is illustrated by the following example:

Example 2. Assume that a California-domiciled corporation and an out-of-state corporation each has business income before interest expense of \$100, interest expense of \$50 and nonbusiness dividends from a nonunitary, out-of-state subsidiary in the amount of \$50. Assume that under the three-factor formula as applied by California, each corporation apportions 30% of its net business income to California.

If the interest offset rule is *not* applied, then the California taxable income of the out-of-state corporation would be \$15 ($((\$100 \text{ business income minus } \$50 \text{ of interest expense}) \times 30\%)$) and the California taxable income of the California-domiciled corporation, which pays California tax on the full amount of its nonbusiness dividend income, would be \$65 ($((\$100 \text{ business income minus } \$50) \times 30\% + \$50 \text{ of nonbusiness dividend income})$). Just as one would expect, the California-domiciled taxpayer has a higher

California taxable income than the out-of-state taxpayer.

Application of the interest offset rule turns this result on its head. Under the interest offset rule, the out-of-state taxpayer's interest deduction is reduced by the full amount of its nonbusiness dividend income. At the same time, the California corporation continues to be permitted to deduct the full amount of its interest expense. Under the interest offset rule, however, its interest deduction is taken against its nonbusiness income allocable entirely to California, rather than against its apportionable business income. Thus, the out-of-state corporation and the California corporation, which one would expect to have a higher California taxable income, each have the *same* taxable income—\$30 (\$100 of business income \times 30%). This is true even though the in-state corporation's nonbusiness dividends are taxable entirely by California and the out-of-state corporation's nonbusiness dividends are constitutionally exempt from California tax.

As this example demonstrates, the interest offset rule penalizes one corporation while at the same time providing a significant advantage to the other.⁹ The sole basis for this disparate treatment is the corporation's state of domicile. A corporation domiciled in California has its tax burdens lessened while an out-of-state corporation bears a proportionally greater tax burden by operation of the

⁹ An alternative means of characterizing this result is that the interest offset rule effectively causes the nonbusiness dividends to be treated as if they were taxable business income. Thus, the out-of-state corporation in effect is required to apportion 30 percent (i.e., \$15) of its nonbusiness, nontaxable dividends to California, and the in-state corporation is permitted to apportion 70 percent (i.e., \$35) of its nonbusiness dividends *outside* California, even though those dividends, under California's rules, should be assigned entirely to California.

interest offset rule. The concept that money is fungible does not justify this result. Money is equally fungible for both corporations. This is a straightforward case of facial discrimination against interstate commerce and, under the Court's precedents, is *per se* invalid.

In sum, by applying the interest offset rule, domiciled taxpayers receive an advantage over nondomiciled taxpayers. Nondomiciled taxpayers effectively are taxed on their nonbusiness dividend income, which is constitutionally protected from taxation by California. As demonstrated by the examples above, the interest offset rule—which wholly fails to match interest expense to the income to which it is attributable—is an unconstitutional attempt to tax income that California is prohibited from taxing.

CONCLUSION

The judgment of the Court of Appeal of California for the First Appellate Division should be reversed.

Respectfully submitted,

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November 12, 1999

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APPENDIX

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APPENDIX

[STATE LOGO]

STATE OF CALIFORNIA
FRANCHISE TAX BOARD
PO Box 1286
Rancho Cordova CA 95741-1286

December 23, 1997

In Reply refer to
392:HW:PC
Mail Stop D-12

Mr. Frank A. Yanover
General Electric Company
12 Corporate Woods Blvd., 3rd Floor
Albany, NY 12211

Re: Protest of Notices of Proposed Assessments
Corporation Number: 0000251
Income Years Ended: 12/84 through 12/86

Dear Mr. Yanover,

In our meeting on December 8, 1997, you indicated that General Electric Company disagreed with the interest offset adjustment, and the June 6, 1997 *Hunt-Wesson* case was mentioned.

As you no doubt are aware, Superior Court decisions such as *Hunt-Wesson* are not citable as precedent. Thus, the Franchise Tax Board is required to enforce a statute unless there is a final court of appeal decision holding the statute unconstitutional. Depending on the outcome of the pending litigation of the *Hunt-Wesson* case, an alternate method may be used to assign interest expense to non-business income. This method is referred to as the asset allocation method. Should the interest offset adjustment be held to be unconstitutional and should the taxpayer appeal the interest offset based on the *Hunt-Wesson* case, the asset allocation method may be used to determine the interest expense allowable.

Authority for the asset allocation method is found in R&TC § 25120 and 18 CCR § 25120(d). 18 CCR § 25120(d) provides for the proration of deductions between business and nonbusiness income where expenses related to both classes of income and the proration method fairly distributes the expense. The basis for an asset allocation method to prorate expenses is that money is fungible and is attributable to all activities of the taxpayer. The asset allocation must be computed on a combined basis which is consistent with the California Supreme Court decision in *Pacific Telephone and Telegraph v. FTB*, 7 Cal. 3d 544. The asset allocation method generally follows the rules set forth in 18 CCR § 24344(c)—the water's edge foreign investment interest offset. The water's-edge interest offset is based on the federal asset allocation method in IRC § 864(e) and federal regulations at § 1.861-9T, with one key exemption. The water's-edge provisions contain special rules for interest on debt deposited in restricted accounts. Use of restricted accounts allows for some additional direct tracing that is not provided for in the federal regulation. The restricted account concept for the assignment of interest expense to nonbusiness dividends will not be used outside the scope of the water's-edge interest offset provisions.

The specific process for applying the asset allocation method is as follows:

- (1) Determine the amount of total interest expense. Total interest expense is the sum of all interest expense for all members of the combined report, less intercompany interest expense.
- (2) Determine any interest from qualified nonrecourse debt. The interest from qualified nonrecourse debt is directly assigned to the asset acquired with the debt, and is considered business or nonbusiness depending on the char-

acter of the related asset. Both the asset and the interest expense are excluded from the asset allocation method.

(3) Determine the asset pool. Assets are valued at average federal tax basis net of depreciation and contra asset accounts (such as bad debt reserves), less intercompany accounts and assets associated with qualified nonrecourse debt. Stock basis in subsidiaries owned more than 50% but not combined is increased by the subsidiaries' earnings and profits for the period in which the stock was held by more than 50%.

(4) Compute the ratio of nonbusiness assets to total assets. Nonbusiness assets includes all nonbusiness assets on the balance sheet (other than those associated with qualified nonrecourse debt), not just those assets paying nonbusiness interest and dividends for the current year.

(5) Determine interest expense assigned to nonbusiness income. The ratio computed in (4) is multiplied by total interest expense determined in (1), less specifically assigned interest expense determined in (2), to determine the amount of interest expense assigned to nonbusiness income.

The amount of interest expense assigned to nonbusiness income using the asset allocation method may not exceed the amount of the § 24344(b) interest offset.

To reiterate, the asset allocation method is an alternate basis for adjustment in the event the interest offset provision of R&TC § 24344(b) is deemed unconstitutional in future litigation. Any information you provide for the asset allocation method will not affect the existing interest offset adjustment.

As we discussed, please provide your computation of interest expense attributable to nonbusiness income using

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the method described above. In addition, please provide the supporting schedules for your computation. Since certain business/nonbusiness income adjustments are still being disputed, please provide a computation for the following scenarios:

1. The gains on [name redacted] and the [name redacted] division are business income.
2. The gains on [name redacted] and the [name redacted] division are nonbusiness income.
3. The gain on [name redacted] is business income and the gain on the [name redacted] division is nonbusiness income.
4. The gain on [name redacted] in nonbusiness income and the gain on the [name redacted] division is business income.

Please provide a response within sixty days. However, if additional time is required, please feel free to call me at the number listed below. To ensure proper handling, attach a copy of page one of this letter to your reply and send to the address shown above or the facsimile number shown below.

Thank you for your cooperation.

/s/ Penny Celiz
PENNY CELIZ, Hearing Officer
Telephone: (916) 845-6964
Facsimile: (916) 843-2166